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The Role of the Commodity Futures Trading Commission Under the Commodity Futures

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NOTES

The Role of the Commodity Futures Trading Commission Under the Commodity Futures Trading Commission Act of 1974

The Commodity Futures Trading Commission Act of 1974[1] is the first major change in federal regulation of futures markets since 1936.[2] The Act attempts to fill the need for federal regulation created by the enormous growth in size and importance of the futures markets. Its central feature is the creation of an independent commission to monitor the 500 billion dollars per year futures trading markets.[3]

The Act does not resolve all of the important issues raised in the recent congressional hearings on futures markets. Instead, the Congress explicitly chose to leave the resolution of several controversial issues to the Commodity Futures Trading Commission (Commission).[4] On the surface, this delegation of authority to the Commission seems sound. There is a danger, however, that the Commission's hearings, like those of the Congress, will attract primarily those with vested interests in particular solutions. The Commission must take affirmative action to seek out diverse views, and, if necessary, undertake its own investigations; otherwise its decisions will necessarily be based on the same industry information that was presented to Congress. This would frustrate the avowed purpose of the Act to create a federal apparatus that can weigh all interests objectively.[5]

After a brief look at the functions of futures markets, the conditions that led to the enactment of the Commodity Futures Trading Commission Act, and the major provisions of the Act, this note will critically examine the information now available on the major issues left to the Commission to decide, point to additional information that would be useful in making judgments on these issues, and recommend solutions. It will then discuss two problems not considered in the 1974 legislation—export controls and margin oversight—suggesting areas for action by the Commission.

1. Pub. L. No. 93-463, 88 Stat. 1389.

2. In 1936 the original federal legislation regulating commodity futures, the Grain Futures Act of 1922, Pub. L. No. 67-331, 42 Stat. 998, was significantly strengthened by amendments, and renamed the Commodity Exchange Act. Pub. L. No. 76-675, 49 Stat. 1491.

3. *See* 120 Cong. Rec. H10,247 (daily ed. Oct. 9, 1974); 120 Cong. Rec. S18,864 (daily ed. Oct. 10, 1974).

4. *See, e.g.*, Pub. L. No. 93-463, §§ 203, 208, 402(b), 414, 416, 88 Stat. 1396, 1400-01, 1412, 1414-15.

5. 120 Cong. Rec. S18,864 (daily ed. Oct. 10, 1974).

I. Functions of Futures Markets

A futures contract[6] is a standardized agreement to purchase or sell a fixed amount of a commodity[7] of a certain grade[8] at a certain future date[9] for a variable price.[10] Several delivery months are established for each type of future traded.[11] The number of commodities in which contracts are traded has increased steadily.[12] The 1974 Act

6. For an excellent discussion of the nature of a futures contract, see R. Teweles, C. Harlow & H. Stone, The Commodity Futures Game 22-24 (1974).

7. The term "commodity" will be used here to signify all of the commodities named in the 1974 Act, and all other goods, articles, services, rights, and interests in which futures contracts are presently or may in the future be traded.

8. The contract specifies a certain basis grade. The seller may choose to deliver a grade other than the basis grade. If he does, the quoted price will be adjusted by either a premium or a discount. J. Baer & O. Saxon, Commodity Exchanges and Futures Trading 135 (1949).

9. Contracts on the physical market, generally known as the cash market, may also provides simply for future delivery. Futures trading on the physical market, however, contemplates actual delivery of a specific lot and grade of some commodity, usually on a definite date. G. Hoffman, Futures Trading upon Organized Commodity Markets in the United States 104-10 (1932).

10. *See* Corn Prods. Refining Co. v. Commissioner, 350 U.S. 46, 47 n.1 (1955). One writer has pointed to five distinctive features of a futures contract. First, the specific provisions of each contract are determined by the rules of an exchange and are only briefly referred to in the actual agreement between the parties. Second, the contract is a "basis contract," which allows delivery of either the "contract grade" or some other grade, at the seller's option but at different prices. Third, the seller is given the option of making delivery at any date between specified limits. Fourth, the enforcement of the contract is ensured by a provision that a specified amount, known as a margin, shall be deposited with some third party by each of the contracting parties. These deposits are intended to protect the seller against a refusal of the buyer to make good his contract in case of a fall in prices, and, conversely, to protect the buyer against a default on the seller's part in case of a rise in prices. Fifth, delivery is made by tendering warehouse receipts from an approved warehouse. C. Hardy, Risk and Risk-Bearing 204-05 (2d ed. 1931).

11. Delivery may be made at the seller's option on any day of the delivery month. J. Baer & O. Saxon, *supra* note 8, at 141. The delivery must be made from an approved storage facility. *Id.* at 142. There are three bases for the selection of months: natural (by climate, annual harvest, or production schedule), concentration of trading volume, and inertia. T. Hieronymus, Economics of Futures Trading 37 (1971).

12. At least 56 new contracts were established by American commodity exchanges between 1960 and 1970, ranging from futures in frozen concentrated orange juice to futures in propane gas. *See* Sandor, *Innovation by an Exchange: A Case Study of the Development of the Plywood Futures Contract,* 16 J. Law & Econ. 119, 122-23 (1973). Following the legalization of the holding of gold by private American citizens, four major American commodity exchanges began trading in gold futures contracts, with varying contract units. N.Y. Times, Dec. 29, 1974, § 6, at 2, col. 3 (late city ed.).

There has been serious dispute as to what goods, services, or other tangible or intangible things should be traded on futures markets. *See* Sandor, *supra,* at 125-26. *See also* J. Baer & O. Saxon, *supra* note 8, at 110-25; Bakken, *Futures Trading—Origin, Development and Economic Status,* in 3 Futures Trading Seminar: A Commodity Marketing Forum for College Teachers of Economics (E. Gaumnitz ed. 1966) [hereinafter Futures Trading Seminar]; Houthakker, *The Scope and Limits of Futures Trading,* in The Allocation of Economic Resources 134 (1959); Powers, *Effects of Contract Provisions on the Success of a Futures Contract,* 49 J. Farm Econ. 833 (1967). Some recently have taken the view that anything that fluctuates in price may properly be the subject of a futures contract. Interview with Shirley Z. Johnson, extends regulatory authority to any goods and articles and all services, rights, and interests in which contracts for future delivery are traded now or will be traded in the future.[13]

Futures contracts may be settled either by delivery of the actual good or by making an offsetting transaction any time before the delivery date. If delivery is made and taken, title passes and the buyers and sellers liquidate their positions.[14] In practice, however, about ninety-nine per cent of futures contracts are settled by offsetting transactions,[15] in which the holder of a contract to sell liquidates his position by purchasing a contract to buy the same commodity, or the holder of a contract to buy cancels his position by acquiring a contract to sell. To illustrate, if a trader who has already bought five October soybeans futures contracts sells five October soybeans futures contracts before October, the second transaction is matched against the first and the value difference between the two contracts is settled.[16]

Futures contracts are bought and sold on exchanges.[17] Trading at

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Assistant Counsel, Senate Antitrust and Monopoly Subcomm., Washington, D.C., August 16, 1974 (memorandum of interview on file with the *Michigan Law Review*) [hereinafter Johnson Interview].

13. Pub. L. No. 93-463, § 201(b), 88 Stat. 1395.

14. *See* T. HIERONYMUS, *supra* note 11, at 38; Campbell, *Trading on Futures Under the Commodity Exchange Act*, 26 GEO. WASH. L. REV. 215, 217 (1958).

15. United States v. New York Coffee & Sugar Exch., 263 U.S. 611, 616 (1924); Chicago Bd. of Trade v. Olsen, 262 U.S. 1 (1924); J. BAER & O. SAXON, *supra* note 8, at 138; G. HOFFMAN, FUTURE TRADING AND THE CASH-GRAIN MARKETS 7 (U.S. Dept. of Agriculture Circular No. 201, 1932); Hoffman, *Governmental Regulation of Exchanges*, ANNALS OF THE AM. ACAD. OF POL. & SOC. SCI., May 1931, pt. 1, at 43-48; Irwin, *Legal Status of Trading in Futures*, 32 ILL. L. REV. 155, 156-57 (1937); Taylor, *Trading in Commodity Futures—A New Standard of Legality?*, 43 YALE L.J. 63, 89 (1933).

16. As a further example, suppose *A* buys 1000 bushels of wheat in January for delivery in March at $2.20 a bushel. *A*'s broker makes the offer on an exchange and it is accepted by *B*'s broker, who has an order from *B* to sell 1000 bushels of wheat for March delivery. To facilitate trading, the clearing house now becomes the opposite party to both *A* and *B*. Assume that in February the price of March wheat futures contracts has risen to $2.30 a bushel. *A* decides to settle his contract, and therefore contracts on the exchange to sell 1000 bushels of March wheat to *C*. The clearing house, seeing that this transaction places *A* in the position of having contracted both to buy and to sell 1000 bushels of wheat for March delivery, cancels the two contracts. Since *A* contracted to buy the wheat at a price 10 cents per bushel lower than the price at which he agreed to sell, the clearing house will pay him $100. *See* J. BAER & O. SAXON, *supra* note 8, at 164-96; T. HIERONYMUS, *supra* note 11, at 39-44. Although most futures contracts are liquidated without delivery, the fact that deliveries can be made and taken is important in establishing and maintaining a relationship between cash and futures prices. *See* Chicago Bd. of Trade v. Olsen, 262 U.S. 1, 38 (1923); T. HIERONYMUS, *supra*, at 38-39.

17. For a general description of exchange operations, see J. BAER & O. SAXON, *supra* note 8, at 143-64; T. HIERONYMUS, *supra* note 11, at 10-27. Recently established futures exchanges are organized under Membership Corporation Laws, while the older exchanges were organized as corporations by special acts of state legislatures. *Id.* at 266. It has been held that an exchange is essentially a voluntary association. People v. Chicago Bd. of Trade, 80 Ill. 134, 137 (1875). *Accord*, Turner v. Chicago

most exchanges is carried on in a large room or hall in which there are usually pits for each commodity traded. Speculators deal through futures commission merchants (FCM's), who act as intermediaries between the broker on the exchange floor and the customer.[18] The agreement between an FCM and his customer gives him limited power of attorney for the execution of orders and imposes certain conditions on the customer.[19] A trader who has agreed to purchase is said to be long; a trader who has agreed to sell is said to be short.[20]

Exchange rules usually require that information about a transaction be reported to the exchange clearing house at some time during the day that the transaction is made. After the trade is made on the floor, the FCM deals exclusively with a clearing member or with the clearing house, if the FCM is a clearing member.[21] The clearing house is thus a party to all trades; it serves as a buyer to all sellers and a seller to all buyers.[22] Each day the clearing house announces the settlement price from that day's trading for each contract traded.[23] This figure serves as the basis for determining the amount to be collected or disbursed by the clearing house in settling that day's transactions.[24]

One student of the exchanges has categorized traders into four somewhat distinct groups, according to their trading functions.[25]

Bd. of Trade, 244 Fed. 108 (7th Cir.), *cert. denied*, 245 U.S. 667 (1917); Thomson v. Thomson, 293 Ill. 584, 127 N.E. 882 (1920).

18. A futures commission merchant (FCM) is an individual, association, partnership, corporation, or trust "engaged in soliciting or in accepting orders for the purchase or sale of any commodity for future delivery on, or subject to the rules of, any contract market." U.S. DEPT. OF AGRICULTURE, FEDERAL REGULATION OF TRADING IN COMMODITY FUTURES CONTRACTS 44 (1973).

19. For a description of the terms of agreements between brokers and customers, see T. HIERONYMUS, *supra* note 11, at 53-54. For a discussion of the legal relationship between brokers and customers, see G. HOFFMAN, *supra* note 15, at 165-66. Hieronymus identifies four general kinds of services provided to customers by brokerage houses. First, they offer the best order execution possible, through good communications with skilled brokers on the exchange floors. Second, they act as the customer's agent with the clearing house and prepare accounts for him of his profits and losses. Third, they provide information for customers on market conditions and trends. Fourth, they furnish account executives who act as a personal contact for each customer. For a more detailed discussion, see T. HIERONYMUS, *supra*, at 54-57.

20. *See* T. HIERONYMUS, *supra* note 11, at 39-40; Campbell, *supra* note 14, at 216-18.

21. Clearing houses reconcile all futures contracts and assure the financial integrity of futures transactions. For a detailed discussion, see J. BAER & O. SAXON, *supra* note 8, at 164-87; T. HIERONYMUS, *supra* note 11, at 40-44.

22. Courts have upheld the legality of the clearing system in Clews v. Jamieson, 182 U.S. 461 (1901); Daniel v. Chicago Bd. of Trade, 164 F.2d 815 (7th Cir. 1947); and Crowley v. Commodity Exch., 141 F.2d 182 (2d Cir. 1944).

23. The settlement price is based on the day's closing price or on closing price ranges for each month of each contract. T. HIERONYMUS, *supra* note 11, at 42.

24. *Id.*

25. *Id.* at 44-51. *See also* J. BAER & O. SAXON, *supra* note 8, at 132; G. HOFFMAN, *supra* note 15, at 133-34.

Floor brokers execute the orders they receive from their outside clients and from floor traders.[26] They are currently permitted to trade for their own accounts as well as for the accounts of their customers.[27] *Floor traders* are professional speculators who trade for their own accounts in more than one commodity and who usually hold a large number of contracts. Under current regulations floor traders can also serve as floor brokers. *Scalpers* normally operate only in one pit; they attempt to take advantage of small, short-term price changes by buying at slightly lower and seeking to sell at slightly higher than the last quoted prices. Finally, *pit traders* profit from price changes that occur during the trading day, buying when they think the price is going up and selling when they think it is going down.

It is generally believed that the central function of commodities markets is to provide a means for producers, dealers, and processors of various commodities to ensure against large price fluctuations.[28] This process, called hedging, allows "collectors and exporters of grain or other products, and manufacturers who make contracts in advance for the sale of their goods, to secure themselves against the fluctuations of the market by counter contracts, for the purchase or sale, as the case may be, of an equal quantity of the product, or of the material of manufacture."[29] By reducing the risk of loss from a drop in value of the commodity, hedging enables producers to sell at lower profit margins. Middlemen require less capital and can carry a smaller inventory when assured of predictable costs for raw materials.[30] Consumers benefit because the reduction in the pro-

26. A floor broker is any person "in or surrounding any pit, ring, post, or other place provided by a contract market for the meeting of persons similarly engaged, who shall purchase or sell for any other person any commodity for future delivery on, or subject to the rules of any contract market." U.S. DEPT. OF AGRICULTURE, *supra* note 18, at 44.

27. *Id.*

28. *See* J. BAER & O. SAXON, *supra* note 8, at 197. *But see* Bakken, *supra* note 12, at 15.

29. Board of Trade v. Christie Grain & Stock Co., 198 U.S. 236, 249 (1905). There is considerable disagreement as to what precisely constitutes hedging. *See, e.g.*, Corn Prods. Refining Co. v. Benson, 232 F.2d 554, 563 (2d Cir. 1956); J. BAER & G. WOODRUFF, COMMODITY EXCHANGES 83-121 (3d ed. 1935); BOARD OF TRADE OF THE CITY OF CHICAGO, INTRODUCTION TO HEDGING 3-13 (1972); H. EMERY, SPECULATION ON THE STOCK AND PRODUCE EXCHANGES OF THE UNITED STATES 159-70 (1896); C. HARDY, *supra* note 10, at 71, 222, 226; G. HOFFMAN, *supra*, note 15, at 22; G. HOFFMAN, HEDGING BY DEALING IN GRAIN FUTURES 33-93, 114, 123-24 (1925); L. HOWELL, ANALYSIS OF HEDGING AND OTHER OPERATIONS IN GRAIN FUTURES 3 (U.S. Dept. of Agriculture Technical Bull. No. 971, 1948); MERRILL LYNCH, PIERCE, FENNER & SMITH, THE HEDGER'S HANDBOOK 5-10 (1971); 1 REPORT OF THE FEDERAL TRADE COMMISSION ON THE GRAIN TRADE 207, 210 (1920) [hereinafter FTC REPORT]; 7 *id.*, at 33, 53-54 (1926); Gray, *The Importance of Hedging in Futures Trading and the Effectiveness of Futures Trading for Hedging*, in 1 FUTURES TRADING SEMINAR, *supra* note 12, at 61-70; Hardy & Lyon, *The Theory of Hedging*, 51 J. POL. ECON. 276, 287 (1923).

30. Banks encourage producers and middlemen to hedge. They will usually extend

ducer's and middleman's operating costs lowers the price of the finished product.[31] As commodity producers and processors have become more sophisticated, they have made increasing use of hedging.[32]

Although the value of hedging is generally accepted, speculation in futures has been sharply attacked.[33] Speculators are regarded as suspect because they generally have no actual business use for the physical commodities in which they purchase futures contracts. Rather, their profit or loss is made or suffered entirely from fluctuations in futures prices. Some speculation, however, is essential to provide the market liquidity that enables markets to accommodate bona fide hedging transactions.[34] Through the market mechanism speculators assume the risk of price movement from hedgers. Speculators are needed to perform this function because there is often an imbalance between the short and long hedgers. Some believe that speculation also plays a role in stabilizing commodity prices.[35] The traditional explanation is that speculators become expert at predicting the factors that are likely to affect prices and help to bring about more gradual price changes.[36]

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credit for a higher percentage of the value of goods pledged as security if they have been hedged on a futures market. J. BAER & O. SAXON, *supra* note 8, at 212; T. HIERONYMUS, *supra* note 11, at 131.

31. Wolff, *Comparative Federal Regulation of the Commodities Exchanges and the National Securities Exchanges*, 38 GEO. WASH. L. REV. 227 (1969); Note, *Federal Regulation of Commodity Futures Trading*, 60 YALE L.J. 822, 827 (1951).

32. On the importance of hedging, see Gray, *supra* note 29, at 61-70. Teweles, Harlow and Stone point out that the assumption that hedging will eliminate all risk from price movements is naïve. In practice, hedging is likely only to reduce risks, and many hedgers are in fact engaging in some speculation by means of their hedging position. R. TEWELES, C. HARLOW & H. STONE, *supra* note 6, at 32-43.

33. *See* Campbell, *supra* note 14, at 219 n.17. *See also* J. BAER & O. SAXON, *supra* note 8, at 51-85; T. HIERONYMUS, *supra* note 11, at 136-46. Speculators are prevalent in the futures markets. A United Nations Conference on Trade and Development study of international commodities futures markets found that "much of the sharp increase in the volume of trading since 1970-1972 has been in the form of speculation." W. LABYS, MARKETING AND DISTRIBUTION SYSTEMS FOR PRIMARY COMMODITIES ¶ 8 (1974) (study prepared at the request of the UNCTAD secretariat) [hereinafter UNCTAD STUDY]. *See also id.* ¶ 18.

34. J. BAER & O. SAXON, *supra* note 8, at 73-75.

35. *See generally* A. BRACE, THE VALUE OF ORGANIZED SPECULATION 54-59 (1913); 7 FTC REPORT, *supra* note 29, at 16-18; Note, *supra* note 31, at 828. Baer and Saxon report that in Board of Trade v. Clyne, 260 U.S. 704 (1922), 22 prominent economists filed affidavits in which each "declared his belief that, with infrequent and minor exceptions, futures trading had a marked tendency to stabilize prices." J. BAER & O. SAXON, *supra* note 8, at 69 n.10. *See also* R. TEWELES, C. HARLOW & H. STONE, *supra* note 6, at 14, 45-51. *But see* UNCTAD STUDY, *supra* note 33, ¶ 25.

36. Because many speculators are not experts, the validity of this theory is now being questioned. *See* COMMODITY EXCHANGE AUTHORITY, TRADING IN COMMODITY FUTURES CONTRACTS ON THE CHICAGO BOARD OF TRADE 8-10 (Marketing Research Report No. 999, 1973). *See also* UNCTAD STUDY, *supra* note 33, ¶¶ 26-35.

II. Present Conditions on Futures Markets

Congressional interest in futures markets has been spurred by their dramatic growth in recent years.[37] In 1973, a time that combined severe commodity shortages with widespread inflation, the performance of futures markets became especially controversial.[38] Since the early 1950's, there had been constant commodity surpluses and stable domestic prices.[39] In 1973, increases in world population, per capita income, and food consumption combined with heavy inflation, dollar devaluation, and adverse weather conditions in a number of growing areas to end the "age of surpluses."[40] In this difficult period the pressures on futures markets both to reflect accurately the market situation and to moderate price instability were intense.[41]

The markets reacted with what one advisory service characterized as "mob hysteria,"[42] spawning what was called "the greatest bull market in history."[43] The sudden increase in market volume and price levels was staggering. The 25.8 million futures contracts traded in 1973 represented a forty per cent increase over the volume in 1972, the previous record year.[44] Price levels in some contracts soared to levels almost three times higher than their previous all-time highs.[45]

This major increase in price levels stimulated widespread concern about the functioning of the markets. Critics suggested that speculators had bid up price levels, thereby exerting upward pressure on consumer prices.[46] Exchange spokesmen insisted instead that

37. It is estimated that in 1960, 8.168 million futures contracts were traded, involving a total value of $54.7 billion. By 1972, this figure had increased to 47.009 million contracts, with a value of $399.3 billion. In 1973 the estimated value of contracts traded jumped even more dramatically to $520 billion. Association of Commodity Exchange Firms, Inc., Association Bulletins Nos. 1126, 1127, 1304. *See also Hearings on S. 2485 Before the Senate Comm. on Agriculture and Forestry*, 93d Cong., 2d Sess. 540, 543-46 (1974) [hereinafter *1974 Senate Hearings*].

38. *Compare* 119 Cong. Rec. H8,775 (daily ed. Oct. 9, 1972) *and* 119 Cong. Rec. S18,964 (daily ed. Oct. 10, 1973) *and Hearings Before the Subcomm. on Small Business Problems of the House Permanent Select Comm. on Small Business*, 93d Cong., 1st Sess. 47 (1973) [hereinafter *House Small Business Hearings*], *with id.* at 133, 311.

39. *See, e.g.*, N.Y. Times, Oct. 15, 1973, at 57, col. 5 (late city ed.).

40. Time, April 2, 1973, at 84-85, *quoting* Richard Mayer, Chicago Board of Trade pit trader. *See House Small Business Hearings, supra* note 38, at 89-91; N.Y. Times, Oct. 15, 1973, at 57, col. 5 (late city ed.).

41. *See generally* Mollenhof, Risser & Anthan, *The High Cost of Food Gambling*, The Nation, June 25, 1973, at 813.

42. Money, Aug. 1973, at 28-29, *quoting* Commodity Chart Service, June 1973 Letter.

43. Bus. Week, Dec. 22, 1973, at 118, *quoting* Houston A. Cox, Jr., National Commodities Director, Reynolds Securities, Inc.

44. *Hearings on H.R. 11955 Before the House Comm. on Agriculture*, 93d Cong., 2d Sess. 265 (1974) [hereinafter *1974 House Hearings*].

45. *See* Bus. Week, Dec. 22, 1973, at 118.

46. *See* Mollenhof, Risser & Anthan, *supra* note 41; N.Y. Times, Oct. 15, 1973, at 47, col. 5 (late city ed.).

an "extraordinary coincidence of global events" was the root cause.[47] The increased volatility of commodities prices caused commercial hedgers unexpected losses,[48] while it simultaneously attracted increased numbers of speculators who were encouraged by investment houses anxious to replace their faltering securities business.[49]

The surge in futures prices led some to question the continued viability of the markets.[50] There was "a kind of erosion of faith in the system by people who [had] used it for years,"[51] and some felt that the futures markets were "anachronisms on their way to extinction."[52] In contrast, exchange officials argued that futures markets helped to hold down commodity price levels at a time of extraordinary pressure, and that speculation in fact had a dampening influence on futures price levels.[53]

The disparity between the critics' charges and the claims of the exchanges led to congressional investigations. A House subcommittee investigating the speculative boom concluded that the pattern of self-regulation by the exchanges coupled with oversight by a small federal regulatory agency was outmoded.[54] They recommended the creation of "a Securities and Exchange Commission-type independent regulatory agency with sufficient stature to attract good personnel and more authority . . . ."[55] The House Agriculture Committee found a "crisis" of public confidence in the present regulatory scheme,[56] and a special subcommittee was set up to draft a comprehensive legislative proposal.[57] Several Senators also introduced broad-ranging futures legislation.[58] From the hearings and pro-

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47. *See House Small Business Hearings, supra* note 38, at 135.

48. In volatile markets swift price changes make it difficult to arrange a hedging transaction before the price moves.

49. *See* FORBES, Aug. 1, 1973, at 24.

50. *See generally* Mollenhof, Risser & Anthan, *supra* note 41; *Hearings on the Review of the Commodity Exchange Act Before the House Comm. on Agriculture*, 93d Cong., 1st Sess. (1973) [hereinafter *1973 House Hearings*].

51. 119 CONG. REC. S17,732-34 (daily ed. Sept. 26, 1973), *quoting* Washington Star-News, Sept. 25, 1973.

52. 119 CONG. REC. S23,512-13 (daily ed. Dec. 20, 1973), *quoting* Des Moines Sunday Register, March 4, 1973, *quoting* Walter Groeppinger, President of the National Corn Growers Association. Other critics of futures markets stated they "serve only as gambling casinos with farm products as the chips," N.Y. Times, Oct. 15, 1973, at 58, col. 1 (late city ed.), while the President of the National Consumers Congress charged that "consumers are getting the short end of the stick, because the exchanges do nothing but serve big agri-businesses." Wall St. J., Jan. 11, 1974, at 15, col. 5 (midwest ed.).

53. *See House Small Business Hearings, supra* note 38, at 133-43, 209-15.

54. 114 CONG. REC. H8,776 (daily ed. Oct. 9, 1973).

55. *Id.*

56. H.R. REP. No. 93-975, 93d Cong., 2d Sess. 37 (1974).

57. 120 Cong. Rec. H10,247 (daily ed. Oct. 9, 1974). The proposal introduced became H.R. 13113, 93d Cong., 2d Sess. (1974).

58. *See* S. 2837, S. 2578, S. 2485, 93d Cong., 1st Sess. (1973).

posals emerged the Commodity Futures Trading Commission Act of 1974.

III. Major Provisions of the 1974 Act

Until passage of the 1974 Act, federal regulation of futures markets was governed by the 1936 Commodity Exchange Act.[59] Although it established a form of federal supervision over the exchanges, the 1936 Act provided little federal control over essential exchange functions.[60] The 1974 Act finally establishes effective federal regulatory authority; much of its strength lies in the four provisions discussed below.

A. *Independent Agency*

The Act creates an independent regulatory agency—the Commodity Futures Trading Commission—headed by five commissioners to be appointed by the President with the advice and consent of the Senate.[61] The Commission assumes the regulatory responsibility currently held by a division of the Department of Agriculture, and is intended to be more expert, more prestigious, and less susceptible to political pressure than the old body. It should also be more effective because its mandate extends to a wider range of goods and services and it is better able to determine the public interest.[62]

The previous regulatory system within the Department of Agriculture was inadequate largely because the Department was burdened with other duties. For example, the Secretary of Agriculture was charged with influencing the prices of many commodities.[63] Since prices are supposed to fluctuate freely with supply and demand on the commodities markets, his duty to maintain price levels created a potential conflict of interest with his duty to oversee the markets.[64] There was also a conflict between the Department's role as an advocate for agricultural interests and its neutral position as the supervisor of futures trading. The independence of the new Commission should enable it to avoid such conflicts.

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59. Pub. L. No. 74-675, 49 Stat. 1491.

60. *See* Carey, *Regulation and Supervision of Futures Trading*, in 3 Futures Trading Seminar, *supra* note 12, at 139, 146.

61. Pub. L. No. 93-463, §§ 101-06, 88 Stat. 1389-95. The Commissioners are to be full-time employees of the Commission, and they are not to accept compensation from any person subject to regulation by the Commission. Four of the initial Commissioners have been nominated and confirmed. N.Y. Times, April 20, 1975, § 3 (Business and Finance), at 1, col. 4.

62. *See, e.g.*, H.R. Rep. No. 93-975, *supra* note 56, at 42-53; H.R. Rep. No. 93-438, 93d Cong., 2d Sess. 40-42 (1974); S. Rep. No. 93-1131, 93d Cong., 2d Sess. 20-22 (1974).

63. *See* 7 U.S.C. §§ 601-24, 1281-1393, 1421-68 (1970).

64. *See 1974 Senate Hearings*, *supra* note 37, at 198, 417, 572, 604-05.

B. *Injunctive Powers*

The new Commission is authorized to sue to enjoin any contract market or individual from violating the Act or from restraining trading in any futures contract.[65] Such authority is essential to the effective regulation of volatile markets: If the Commission had been required to refer requests for action to the Attorney General, as most independent agencies must do, there would have been unnecessary delay and the Attorney General would have had virtual veto power.[66] Instead, the new Act requires the Commission only to inform the Attorney General of its actions.

C. *Regulation of All Commodities*

The Act provides the Commission with broad authority to regulate futures trading in all goods, articles, services, rights, and interests traded for future delivery.[67] The extension of regulatory authority to previously unregulated items should promote consistency in exchange operations and in brokers' handling of customer accounts. It should also protect customers from fraudulent operations on futures markets, and it provides the authority to investigate trading activity on all markets.[68] The new Act should thus allow investors to trade with confidence on all American futures markets.

D. *Emergency Powers*

The Act enables the Commission to take special action in emergency situations and to direct a contract market to take measures to maintain or restore orderly trading. The term "emergency" now includes, in addition to potential or actual market manipulations, any act of the United States or a foreign government affecting a futures price and any other market disturbance that prevents the market from accurately reflecting supply and demand.[69] The rapidity with which futures markets respond to external events makes it imperative that the Commission be able to take immediate action in such situations.

IV. ISSUES LEFT TO THE COMMISSION TO DECIDE

A. *Option Trading in Previously Unregulated Futures Contracts*

A commodity option is a right to buy or sell a specified quantity of a particular commodity, or a futures contract for a particular

65. Pub. L. No. 93-463, § 211, 88 Stat. 1402. It should be noted that no restraining order, injunction, or writ of mandamus may be issued *ex parte*.

66. *See 1974 Senate Hearings*, *supra* note 37, at 202-03, 209, 368, 417-18.

67. Pub. L. No. 93-463, § 201, 88 Stat. 1395.

68. *See, e.g.*, H.R. REP. No. 93-975, *supra* note 56, at 61-64; H.R. REP. No. 93-438, *supra* note 62, at 65. It has been suggested that in the past speculators who were prevented from manipulating regulated markets were likely to turn their attention to unregulated markets. *1973 House Hearings*, *supra* note 50, at 10-11.

69. Pub. L. No. 93-463, § 215, 88 Stat. 1404-05.

commodity, at a specified price within a specified period of time.[70] The purchaser pays a "premium" for the option, which varies in amount with the option's duration.[71] In addition to the premium, the purchaser must pay one broker's fee at purchase, and another later if the option is exercised.[72] Should the option purchaser fail to exercise his option, he loses the premium payment completely.[73] Options generally are available for periods ranging from two to fourteen months.[74]

In the past three years, a new breed of commodity options, so-called "naked options," have been sold in this country.[75] Naked options are based on changes in futures prices but are not backed either by futures contracts or by actual ownership of the commodities involved.[76] Limited capital requirements and lack of regulation make entry into naked option trading easy; the potential

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70. The right to buy a specified quantity of the commodity or commodity future at a price specified in the option contract on or before a specified date is called a "call option." The right to sell under such conditions is called a "put option." A "double option" is a combination "put" and "call" on the same commodity. It permits the holder to elect either to buy or to sell, but not both.

The price at which the holder of an option can buy or sell the futures contract is generally called the "striking" or basis price. It is normally the price at which the futures contract is trading when the option is purchased. *See* S. KROLL & I. SHISKO, THE COMMODITY FUTURES MARKET GUIDE 259 (1973); *1974 Senate Hearings, supra* note 37, at 825-27; Long, *The Naked Commodity Option Contract as a Security*, 15 WM. & MARY L. REV. 212-13 (1973); Cal. Corp. Commn. Release No. 29-C, 1 BLUE SKY L. REP. ¶ 8679 (Feb. 8, 1973); DUN'S, March 1973, at 72.

71. "Although the option premium is roughly equivalent to the margin requirement of a futures contract, it can run much higher. The cost goes up, for instance, on longer-term premiums. Critics . . . also charge that some underwriters inflate the premiums so as to be able to offer their sales representatives handsome fees running as high as 20% to 25% of the premium." DUN'S, March 1973, at 71.

72. S. KROLL & I. SHISKO, *supra* note 70, at 260. The broker's fee can be quite high. One options house official stated that some firms were charging broker's fees as high as 12 to 15 per cent on the initial sale, and the same rate on reinvestments by the same customers. DUN'S, March 1973, at 72.

73. As an illustration, assume that Green buys a one-year call option on a silver contract currently worth $18,000 ($1.80 an ounce for 10,000 ounces). He pays a premium of $1000 for the option. For Green to gain a profit, the price of silver must move up by more than 10 cents an ounce. Suppose that six months later, the price has reached $1.95 an ounce. Green exercises his option to buy the contract for his price of $18,000 and then sells it for its present worth of $19,500. His profit after deducting the $1000 cost of the premium will be $500, less the combined brokerage fees for buying the option and selling the contract. A put option simply works in reverse order. *See* Stipulation of All Relevant Facts in Lieu of Trial on Preliminary and Permanent Injunction, SEC v. Goldstein, Samuelson, Inc., Civ. A. No. 73-472 (C.D. Cal. Oct. 11, 1973).

74. S. KROLL & I. SHISKO, *supra* note 70, at 260.

75. *See generally* Long, *supra* note 70; BUS. WEEK, March 10, 1973, at 43; FORBES, Aug. 15, 1973, at 66; Wall St. J., June 28, 1973, at 38, col. 1 (eastern ed.).

76. Long, *supra* note 70, at 220.

for abuse is correspondingly high.[77] Moreover, naïve investors are attracted to this area by its "get-rich-quick" potential.[78]

The first comprehensive legislation regarding options was the Commodity Exchange Act of 1936, which banned option trading in all domestic commodities regulated by the Act.[79] Trading in options on commodities not regulated by the Act[80]—mostly nonagricultural international commodities—was not affected.[81] Pressure to

77. *See, e.g., id.* at 212-30; BARRON'S, Jan. 8, 1973, at 5, col. 2; DUN'S, March 1973, at 69-72, 119-20; FORBES, Aug. 15, 1973, at 66.

Options were identified in the late nineteenth century as one of the most easily abused aspects of futures trading; they were intermittently allowed and prohibited on exchanges for many years prior to 1936. As early as 1892 the Chicago Board of Trade attempted to improve its reputation as a legitimate commercial institution by prohibiting options. However, the directors did not vigorously attempt to discourage their members from trading in options, and when some continued to do so, others followed. *Hearings on Futures Trading Before the House Comm. on Agriculture*, 66th Cong., 3d Sess. 945, 949 (1921) [hereinafter *1921 Hearings*]. Many exchange officials became convinced that the economic benefits of options were outweighed by the danger of their possible use to dominate futures markets. *See, e.g., Hearings on H.R. 6772 Before the Senate Comm. on Agriculture and Forestry*, 74th Cong., 2d Sess. 220 (1936) (letter from Board of Directors of the Chicago Board of Trade to J.P. Griffin, President, Chicago Board of Trade, April 12, 1921) [hereinafter *Hearings on H.R. 6772*]. Since buying options may sometimes be less expensive than buying the underlying futures contract, a speculator in options can dominate a market with less of an investment. This potential for abuse was deemed dangerous enough to outlaw options as early as 1921. *See id.* at 220-24. In addition, some felt that options trading was a prime cause of excessive price movements. *See id.* at 224. By the time of the adoption of the federal ban in 1936, trading in options was already prohibited by the rules of many major futures exchanges. *See id.* at 225.

78. There is an alarming number of cases of fraud based on naked option schemes. *E.g., In re* Goldstein, Samuelson, Inc., 3 BLUE SKY L. REP. ¶ 71,095 (Okla. Sec. Commn., Feb. 23, 1973); Shapiro v. First Federated Commodity Trust Corp., 3 BLUE SKY L. REP. ¶ 71,058 (Md. Cir. Ct., Baltimore Co., Feb. 27, 1973). *See also* N.Y. Times, Oct. 3, 1974, at 61, col. 1 (late city ed.). Such cases caused many states to stiffen their commodity option regulations. *See, e.g.,* California Assembly Bill No. 799 (Sept. 25, 1973).

79. 7 U.S.C. § 6c(B) (1970). Several attempts to prohibit commodity options were made before 1936, but they were confined to one exchange or to a single state. *E.g.,* OHIO REV. CODE ANN. § 2915.20 (Page 1953). *See also 1921 Hearings, supra* note 77, at 945, 949.

80. These included silver, silver coins, platinum, cocoa, copper, coffee, and world sugar.

81. Some options were written by domestic firms, but many of those trading in options chose to buy through the London commodity market.

There are two major recognized types of options: Mocatta options and London options. The members of exchanges handling Mocatta options are dealers in the cash or physical commodities themselves. Their options are covered by inventories of the physical commodity as well as by futures contracts for such commodities. Such options derive their name from the extensive dealings in them by the Mocatta Metals Corporation. *1974 Senate Hearings, supra* note 37, at 827.

London options are so called because they are traded in London and often guaranteed by the International Commodities Clearing House Ltd. in London, a part of the United Dominions Trust Group. The Clearing House handles both futures contracts and options for futures contracts. In order to exercise an option, it is necessary to make a request to the Clearing House that such an option be declared. The Clearing House then substitutes an appropriate futures contract for the option and sends a registration statement to both parties. The premium paid is turned over outlaw fraudulent dealings in commodity options continued, however, and was a major factor leading to the 1974 Act.[82] In response to the criticisms of option dealing, all of the comprehensive bills introduced in the Ninety-third Congress contained a flat prohibition on commodity options.[83] Congress continued the existing ban on options in regulated commodities in the Act as passed. However, under strong pressure from those currently engaged in trading unregulated options,[84] Congress delegated to the Commission the question of banning options in newly regulated commodities.

The Commission must fully consider the pros and cons of option trading before making its decision. It would be a mistake to interpret Congress' decision to delegate the issue to it as an indication of an intent to allow option trading in previously unregulated commodities. Neither the House nor the Senate Committee Report gives any clear guidance to the Commission in making this decision. In the absence of current legislative guidance, the Commission should give attention to the arguments that Congress considered persuasive in enacting the 1936 ban on options. In addition, recent experience and research raises questions about the arguments presently made by the options advocates.

The fact that the 1936 ban on options in regulated commodities has not made domestic futures markets less effective places a heavy burden of justification on those advocating continuation of previously unregulated option trading. Proponents of option trading have attempted to demonstrate that the situation in international futures markets is distinguishable from that in the domestic market, and that options would serve a valuable function in the former, even though the judgment had been made to ban options in the latter.[85] Thus, the international commodity exchanges in New York

to the Clearing House and released only upon execution or abandonment of the option. Options currently are guaranteed in sugar, coffee, cocoa, wooltops, soybean oil, sunflower-seed oil, coconut oil, and cotton. *See* INTERNATIONAL COMMODITIES CLEARING HOUSE LTD., LONDON COMMODITY OPTIONS (1974) [hereinafter LONDON COMMODITY OPTIONS]; *1974 Senate Hearings, supra,* at 827; BUS. WEEK, Dec. 21, 1974, at 145.

82. *See, e.g., 1973 House Hearings, supra* note 50, at 11; H.R. REP. No. 93-975, *supra* note 56, at 37-39.

83. H.R. 13113, 93d Cong., 1st Sess. 1973 (addition of § 201 without altering 7 U.S.C. § 6c(B) (1970)); S. 2837, 93d Cong., 1st Sess. § 308(b)(2) (1973); S. 2485, 93d Cong., 1st Sess. § 6c(B) (1973); S. 2578, 93d Cong., 1st Sess. (1973) (addition of § 7 without altering 7 U.S.C. § 6c(B) (1970)).

84. The hearings include several detailed statements on the benefits of option trading. *See, e.g., 1974 House Hearings, supra* note 44, at 37, 132, 176, 190, 276; *1974 Senate Hearings, supra* note 37, at 463, 502, 539, 730, 795, 809. *Cf. 1921 House Hearings, supra* note 77, at 945, 949; *Hearings on H.R. 6772, supra* note 77, at 220-24.

85. *See, e.g., 1974 House Hearings, supra* note 44, at 246, 276. Options proponents have noted that the London options market is backed up by a clearing house, and they have pointed to the utility of domestic metals options. *See id.* at 176, 190. However, they have neglected to add that only some of the London options are covered by the clearing house. Furthermore, this clearing house is a private, profit-making

have asserted that option trading adds a measure of liquidity to their markets that is not needed in domestic markets.[86] This argument is weakened by the fact that the exchanges have thus far managed to conduct adequate markets in regulated commodities without options. Their need for additional liquidity rests on the assertion that the new regulation of their markets authorized by the 1974 Act will drive much of their business abroad,[87] an assertion that Congress rejected in deciding to regulate them.[88]

Thus, there is little merit in the attempt to separate options in domestic agricultural commodities from international commodity options. Moreover, all of the other arguments made in favor of option trading have drawbacks that are overlooked by their proponents. First, the options advocates frequently point to the economic justifications for option trading. They argue that by investing in options, a company can hedge its inventory without tying up all of the capital necessary to make the margin payments on a futures contract,[89] and note that an option purchaser can limit the maximum extent of his loss, thus facilitating planning.[90] In fact, there is often little difference between the costs of options and futures contracts. Although options do allow investors to limit potential loss, the premium and commission charges on options usually approximate the margin requirements of futures contracts.[91] In order to make a profit, an investor must make more than the brokerage fee.[92] By trading in options the speculator thus sacrifices the opportunity to clear a profit on a relatively small market rise; his investment is usually of an "all or nothing" character.

A second justification for option trading is that options may be used to finance speculative transactions with small amounts of

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institution, subject to little regulation. *See* LONDON COMMODITY OPTIONS, *supra* note 81; INTERNATIONAL COMMODITIES CLEARING HOUSE LTD., A BACKGROUND NOTE (1973); *1974 House Hearings, supra*, at 176.

86. *1973 House Hearings, supra* note 50, at 120-21; *1974 House Hearings, supra* note 44, at 267.

87. *1973 House Hearings, supra* note 50, at 120-21.

88. It was also argued that Congress could reasonably choose not to reexamine the existing prohibition on options without having to extend that prohibition to options in the newly regulated commodities. "[T]he principal thrust of today's efforts," it was contended, was to increase regulatory safeguards, rather than to alter drastically an entire area of ongoing economic activity. *1974 House Hearings, supra* note 44, at 193. However, the 1974 Act itself recognizes that in order to increase regulation, coverage must often be extended.

89. *See* text at notes 263-64 *infra*.

90. *See 1974 House Hearings, supra* note 44, at 190-92, 267-68.

91. *See* note 71 *supra*.

92. As a result, speculators or hedgers in options usually either lose their entire investment or at least double it. Interview with Houston A. Cox, Jr., Vice-President, Reynolds Securities, Inc., New York City, Oct. 10, 1973 (memorandum of interview on file with the *Michigan Law Review*).

capital.[93] Options advocates suggest that this results in savings to producers, processors, and manufacturers and in lower consumer prices for finished goods. In fact, however, the size of the premium and commission charges[94] paid on option contracts makes the savings less significant, and any advantage gained from such savings must be weighed against the danger that financially insecure traders or fraudulent promoters will be attracted.

Supporters of option trading assert that the increased trading facilitated by options increases the stability of futures markets. They cite studies of speculation on futures markets suggesting that speculation reduces price fluctuations.[95] Supposedly, speculators sell when prices are high, increasing supply and lowering prices, and buy when prices are low, increasing demand and raising prices.[96] A 1934 study did find that a stabilizing influence results from option trading,[97] but that study proceeded solely on the theory that speculators in options tend to trade against price movements. In a pioneering article in 1937, H. S. Irwin suggested that in fact much trading on exchanges is movement trading,[98] in which investors buy when prices are advancing and sell short when prices are declining. Movement trading is still a factor on today's markets.[99] Such behavior tends to exaggerate fluctuations, and options make movement trading even more attractive, because they limit the loss from guessing wrong. Thus option trading may increase market volatility, as has long been suspected.[100]

It is also argued that if American brokerage houses and international firms are barred from trading in options, they will be at a competitive disadvantage with foreign firms that can so trade.[101] Brokerage houses fear that this will cause business to shift abroad. International commodity options, however, are used only by a small number of sophisticated dealers.[102] Since it is questionable whether

93. P. MEHL, TRADING IN PRIVILEGES ON THE CHICAGO BOARD OF TRADE 78 (Dept. of Agriculture Bull. No. 323, 1934).

94. *See* notes 71, 72 *supra.*

95. *See 1974 House Hearings, supra* note 44, at 200.

96. *Id.*

97. *Id.* at 192.

98. Irwin, *The Nature of Risk Assumption in the Trading on Organized Exchanges,* 27 AM. ECON. REV. 267 (1937).

99. Working, *Tests of a Theory Concerning Floor Trading on Commodity Exchanges,* in 7 STANFORD FOOD RESEARCH INSTITUTE STUDIES 24-28 (Supp. 1967).

100. *See, e.g.,* P. MEHL, *supra* note 93, at 76-78; *Hearings on H.R. 6772, supra* note 77, at 224.

101. *See, e.g., 1974 House Hearings, supra* note 44, at 190, 246.

102. It has been estimated that London options constitute something less than five per cent of the transactions handled by the International Commodities Clearing House Ltd., in London. *Id.* at 176. Because of the relatively high premium charged, few small investors are attracted. *1974 Senate Hearings, supra* note 37, at 827-28.

options cost less than futures contracts, an options prohibition may simply cause some clients to conclude that they can hedge just as effectively without options.

The proponents of option trading further argue that regulation can control abuses in option markets, thus restoring public confidence and making a complete prohibition unnecessary.[103] For example, they assert that anyone familiar with option trading will be able easily to identify financially irresponsible schemes by observing the low premiums charged.[104] But adequate regulation may not be so simple. The limited capital requirements for entering into option trading allow firms to begin operation and prey on unsophisticated investors before regulation can be effective. A half-century of problems suggests that effective regulation of options is difficult, if not impossible.

Finally, the proponents of option trading point to the London option market as evidence that a reliable and economically useful option market is possible. However, in that market actual holders of futures contracts write single options on each contract.[105] Many American option underwriters work on the different premise that option payments can be secured by holding futures contracts for a fixed percentage of the options issued.[106] There are real questions as to what percentage reserve is necessary, and whether such a system can be safe at any percentage.[107]

It may be that the Commission will need to undertake new studies of the economic benefits of international commodity options and their effect on market stability before reaching a decision to prohibit or to allow option trading in heretofore unregulated commodities. Any decision must balance the long record of concern over market volatility and customer fraud against the benefits cited by option trading proponents. It is submitted that without new and convincing evidence, the marginal economic benefit of option trading does not outweigh the proved potential for harm.

B. *Time-Stamping and Identification of Traders in Daily Reports*

Of immediate concern to the Commission is the kind of information needed to supervise the commodity markets adequately. The

103. *See 1974 House Hearings, supra* note 44, at 267-68.

104. *See id.* at 194.

105. London Commodity Options, *supra* note 81.

106. *See* Long, *supra* note 70, at 220-21.

107. In addition, an option dealer in America could not use the futures market simultaneously to underwrite the purchase and sale of an option. If a dealer underwrites a purchase and a sale on the same futures contract, he cannot both buy and sell a futures contract on an exchange, because his transactions would nullify each other. One solution may be to require option writers to specialize in one type of future or one type of option, but this may be economically impractical for dealers.

old Commodity Exchange Authority was criticized for making insufficient use of the information available to it.[108] The new Commission, therefore, should establish clear requirements with respect to the daily trading information it will use and use that information fully.[109]

One heated controversy concerns the need for recording the names of all traders in the clearing house records. The exchanges have argued forcefully that requiring this information would be a violation of confidentiality, that the information could not readily be obtained,[110] and that sufficient information for regulation is already recorded. Nevertheless, there are persuasive reasons why this information is both essential to effective regulation and feasible to acquire.

In most exchanges, observers are stationed in raised pulpits at each pit. These observers record the prevailing prices and times at which trades are made and feed this information into a communications system. The prices are then sent out over the wire services. Each participant in a trade notes on a card the price, quantity, delivery month, and other participant for each transaction. This is the second record of the trade, which is submitted to the clearing house for reconciliation with the record of the other participant at the end of the day. The clearing house will keep this record if it is accurate,[111] but it will know only the identity of the customer's floor representative for the trade and not the identity of the customer himself.[112] To determine the identity of the actual trader, the exchange member who conducted the trade must be consulted.[113] The exchanges have argued that, since the identity of traders is ultimately available, it is not necessary to require traders to identify themselves to the clearing houses.[114] However, the current, indirect method of investigating possible abuses is cumbersome and time-consuming, especially

108. *See, e.g.*, THE COMPTROLLER GENERAL OF THE U.S., REPORT TO THE CONGRESS ON THE NEED TO STRENGTHEN REGULATORY PRACTICES AND STUDY CERTAIN TRADING ACTIVITIES RELATING TO COMMODITY FUTURES MARKETS 8-14 (1965) [hereinafter 1965 REPORT OF THE COMPTROLLER]; OFFICE OF THE INSPECTOR GENERAL, U.S. DEPT. OF AGRICULTURE, AUDIT REPORT OF THE COMMODITY EXCHANGE AUTHORITY 8, 23-26 (1971) [hereinafter OIG REPORT].

109. The drafters of one proposed bill explicitly set forth the information exchanges should be asked to supply to federal authorities. Johnson Interview, *supra* note 12. This provision was adopted by the Senate, S. REP. No. 93-1131, *supra* note 62, at 9, 44, but was modified in conference, so that the decision as to what information should be required was left to the Commission. Pub. L. No. 93-463, § 415, 88 Stat. 1415.

110. *See 1974 Senate Hearings, supra* note 37, at 309, 342-43, 403, 534-36.

111. For more detail, see T. HIERONYMUS, *supra* note 11, at 30-32, 40-44.

112. *1974 Senate Hearings, supra* note 37, at 204.

113. *See* COMMODITY EXCHANGE AUTHORITY, U.S. DEPT. OF AGRICULTURE, FINAL REPORT OF THE JOINT USDA-INDUSTRY STUDY TEAM ON FUTURES TRADING DATA SYSTEMS 14-15 (1974) [hereinafter FUTURES DATA REPORT].

114. *See 1974 Senate Hearings, supra* note 37, at 534-36.

when a large number of transactions is being investigated. Information on the activities of a single trader or group of traders is not readily available. Moreover, Commodity Exchange Authority investigations, or trade-practice investigations,[115] have generally involved detailed examinations of all trades of futures contracts in a particular commodity on a particular exchange during a specified time period.[116] These investigations have been inhibited by the need to consult several sources to obtain necessary information.[117]

A related and important issue is whether to require exchange clearing houses to include the time of each trade in daily trading reports to the Commission. Only two small exchanges presently require brokers to time-stamp trades as they are made.[118] On the larger exchanges, a trade is time-stamped when the order is received by the broker on the exchange floor and again when he returns it from the floor to the clearing member's representative.[119] Much time may elapse between these events, and when trading is active it may become impossible to determine when a trade was made.

Both the Comptroller General and the Administrator of the Commodity Exchange Authority have concluded that certain abusive practices are virtually impossible to detect without more accurate time-stamping.[120] The final report of the Joint USDA-Industry Study Team on Futures Trading Data Systems concluded: "Lack of precise information on the time of execution has handicapped regulation. The ability to reconstruct the exact sequence of trades has proven to be particularly valuable in investigating alleged trade practice violations. Such investigations have been thwarted on occasions by the inability to reconstruct trading. The timing of trades is also important for certain types of manipulation investigations."[121]

115. "According to the CEA, trade-practice investigations represent the best means by which it can obtain information concerning the general trading practices on a futures market and detect violations in trading practices." 1965 REPORT OF THE COMPTROLLER, *supra* note 108, at 9. A fundamental purpose of the Commodity Exchange Act, unchanged by the 1974 Act, is to guard against speculation, manipulation and control, and sudden or unreasonable fluctuations in prices that are detrimental to producers, handlers, and consumers. 7 U.S.C. § 5 (1970).

116. For more detail, see 1965 REPORT OF THE COMPTROLLER, *supra* note 108, at 8-9. The CEA has been criticized for conducting too few investigations, and for failing to follow up those that have been conducted. *See* materials cited note 108 *supra*. For a discussion of past studies of CEA trades-practice investigations and their shortcomings, see FUTURES DATA REPORT, *supra* note 113, at 1-3.

117. *See* OIG REPORT, *supra* note 108, at 6.

118. These are the Minneapolis Grain Exchange and the New York Mercantile Exchange. 120 CONG. REC. S18,867 (daily ed. Oct. 10, 1974); FUTURES DATA REPORT, *supra* note 113, at 41.

119. FUTURES DATA REPORT, *supra* note 113, at 40.

120. 120 CONG. REC. S18,868 (daily ed. Oct. 10, 1974) (Letter from the Comptroller General to Senator Clark, Sept. 16, 1974 [hereinafter Letter of Comptroller General]; Letter from Alex Caldwell, Administrator, Commodity Exchange Authority, to Senator Talmadge, Sept. 11, 1974 [hereinafter Caldwell Letter]).

121. FUTURES DATA REPORT, *supra* note 113, at 5.

Futures exchanges frequently experience rapid price movements. A difference of seconds in the execution of a contract can result in a substantial price difference.[122] Detection of abusive practices will be greatly aided if federal regulators can obtain data about the order of trades and the identity of traders from a single source.[123] Thus, accurate time-stamping would aid detection of floor brokers and futures commission merchants who trade for themselves before they fill customers' orders,[124] or who favor certain customers over others.[125] Such information also would help determine whether traders were improperly manipulating the closing price for a particular contract on a given day.[126] The need for adequate information is highlighted by recent official reports finding substantial evidence of previously undetected violations of trading rules.[127]

Some exchanges have contended that time-stamping is impractical and would disrupt futures markets,[128] but there are strong indications to the contrary. Time-stamping is already required on two exchanges,[129] and the Administrator of the Commodity Exchange Authority has stated that its extension to all exchanges is feasible.[130] He admitted that time-stamping might delay execution or reporting of trades, but concluded that the problems would not be significant. The final report of the recent Joint USDA-Industry Study Team on Futures Trading Data Systems suggested several alternative pro-

122. *See House Small Business Hearings, supra* note 38, at 58-59.

123. As the Assistant Secretary of Agriculture, Richard L. Feltner, explained to the Senate Agriculture Committee: "The major purpose of this legislation, of course, is to increase the ability to regulate . . . . The more information you have about the people who are trading, about the timing of trades, and exactly what took place, the more effective job you are going to be able to do of regulating this market." *1974 Senate Hearings, supra* note 37, at 243.

124. *See* text at notes 140-200 *infra*. Time-stamping also would help to determine the extent of market participation by floor traders, and the influence of such participation on futures prices. *See* FUTURES DATA REPORT, *supra* note 113, at 40.

125. For a more detailed discussion, see *id*. at 38-40.

126. In its report on the Russian grain transaction, the Permanent Subcommittee on Investigations of the Senate Committee on Government Operations stated that the failure to record the times of trades made it impossible to determine whether orders to buy and sell on the Kansas City Board of Trade had affected closing prices. Such information was needed to determine whether large grain exporters were attempting to push up closing prices in order to increase the export subsidies paid to them by the United States government on their sales of grain to Russia. Letter of Comptroller General, *supra* note 120.

127. *See, e.g.*, OIG REPORT, *supra* note 108, at 7. These findings, combined with numerous allegations in the press, compelled the Congress to require closer surveillance of the markets. *See, e.g.*, 119 CONG. REC. S23,502-20 (daily ed. Dec. 20, 1973); 119 CONG. REC. S17,732-34 (daily ed. Sept. 26, 1973), *quoting* Washington Star-News, Sept. 25, 1973; Mollenhof, Risser & Anthan, *supra* note 41, at 813.

128. *See, e.g.*, 120 CONG. REC. S18,867 (daily ed. Oct. 10, 1974); 120 CONG. REC. S18,872 (daily ed. Oct. 10, 1974) (Letter from John Rainbolt, Associate Counsel, House Agriculture Comm., to the Editor, Washington Star-News, Oct. 3, 1974).

129. *See* note 118 *supra* and accompanying text.

130. Caldwell Letter, *supra* note 120.

cedures by which information on execution times could be conveniently reported.[131]

The exchanges have made the additional argument that preserving the confidentiality of traders' identities and times of trades outweighs the benefits of having this information collected.[132] They claim that traders may be disadvantaged if it becomes known that they are long or short in particular contracts.[133] But information on traders' positions is often available even on current markets, and has not seriously hampered traders' operations. Moreover, information collection systems can be designed to protect confidentiality. For instance, the Joint USDA-Industry Study Team on Futures Trading Data Systems has suggested a data system designed to allow the federal authorities to match each trade and each trader on the basis of the filings of traders and clearing members on each trade.[134] The trade information would not be matched with the identity of the traders before reaching the federal regulators.[135]

The inclusion of the time of the trade and the identity of the trader in the information supplied to the clearing houses would be only a small addition to the data already supplied. Yet, one legislator has called the provision allowing the Commission to require such information[136] "potentially of more importance to the enforcement of this act than any other provision therein."[137] The present Commodity Exchange Authority Administrator has indicated that a change in information requirements will not be difficult to institute.[138] The legislative history of the 1974 Act strongly suggests the intent of the Congress to include time and identity information

131. *See* FUTURES DATA REPORT, *supra* note 113, pt. 4.

132. *See id.* at xviii.

133. *See, e.g., 1974 Senate Hearings, supra* note 37, at 342-43.

134. *See generally* FUTURES DATA REPORT, *supra* note 113.

135. There is a strong argument that it would be more efficient to compile this information at the clearing-house level. Since clearing houses receive all available information except the identity of the trader and the time of the trade, it would be more economical to add that data to their records than to burden the federal authorities with matching two data pools. One exchange has claimed that requiring this information to be included in its records might jeopardize its ability to clear each day's transactions overnight, *1974 Senate Hearings, supra* note 37, at 536, but this argument is not persuasive. As Senator Clark commented, "[y]ou [the exchange] keep hundreds of bits of information. It doesn't seem to me that [keeping traders' identities and time records] would add any great additional burden, if it were deemed important." *Id.*

136. Pub. L. No. 93-463, § 415, 88 Stat. 1415, *amending* Commodity Exchange Act § 4g(2), 7 U.S.C. § 6g(2) (1970).

137. 120 CONG. REC. H10,262 (daily ed. Oct. 9, 1974) (remarks of Representative Wampler).

138. As the Administrator pointed out, the information will come from the clearing members and not from individual traders. Clearing members already report all information except the time of the trade and the name of the trader to the clearing house and in some cases even the name of the customer is included. *1974 Senate Hearings, supra* note 37, at 244; Caldwell Letter, *supra* note 120.

in trading reports as soon as practically possible.[139] With this background, the Commission should find the case for requiring new information compelling.

C. *Elimination of Conflicts of Interest*

Few issues in the recent debate on futures trading reform have provoked as much disagreement as the question whether floor brokers and futures commission merchants should be permitted to engage in dual trading, that is, trading for their own accounts as well as for the accounts of their customers. The Congress delegated this issue to the new Commission, but required that it be resolved within six months.[140] The Commission may continue to hold hearings after its initial decision, and it may adjust its rules to meet the needs of changing conditions. However, as Senator Clark has pointed out, "[i]t is likely that the chief witnesses—and perhaps the only ones—before a Commission hearing on the subject would be the exchanges. Since the exchanges are made up of floor brokers, there is no doubt that the exchanges will argue that dual trading is essential . . . ."[141] Yet, there is considerable evidence that the present practice of allowing dual trading is detrimental to the interests of producers, handlers, and consumers—the parties that federal futures regulation should protect.[142]

In the quickly moving futures markets, the speed with which customer orders are filled can make an enormous difference in contract price. Currently, a customer's order to buy or sell a futures contract is transmitted to a futures commission merchant[143] (FCM) or to a floor broker,[144] who fills the order. Under the old Commodity Exchange Act, the order must be filled on the floor of the exchange by "public outcry"; the FCM or floor broker cannot himself assume the other side of the contract.[145] However, the floor broker may trade for himself or for the FCM for whom he works at the same time he fills customer orders.[146] Thus, a floor broker may trade for himself one moment and trade to fill a customer's order the next. Also, because most FCM's employ several floor brokers, one broker may fill a customer order by trading with another broker who works

139. *See, e.g.,* 120 CONG. REC. S18,866-72 (daily ed. Oct. 10, 1974); 120 CONG. REC. H10,262-63 (daily ed. Oct. 9, 1974).

140. Pub. L. No. 93-463, § 203, 88 Stat. 1396.

141. *1974 Senate Hearings, supra* note 37, at 204.

142. *See* 7 U.S.C. § 5 (1970). Several government reports and a House Committee Report have recommended that dual trading by brokers be forbidden. *See, e.g.,* H.R. REP. No. 93-963, 93d Cong., 2d Sess. 52-54 (1974); OIG REPORT, *supra* note 108.

143. *See* note 18 *supra* and accompanying text.

144. *See* note 26 *supra* and accompanying text.

145. *See* Commodity Exchange Act § 4b, 7 U.S.C. § 6b (1970).

146. *See generally* H.R. REP. No. 93-963, *supra* note 142, at 52-54.

for the same FCM, and who is trading for his own account or for the house account of the FCM.

Critics argue that this system is ripe for abuse because FCM's and brokers are given incentive to realize on favorable trading opportunities for their own accounts, rather than for the accounts of their customers.[147] Furthermore, public confidence in the futures markets is eroded because a customer who makes a bad trade has good reasons to suspect his FCM or floor broker of a breach of duty. The exchanges respond, first, that there is no problem; second, that to the extent that there is a problem, it can be adequately handled by regulation; and, finally, that the elimination of such problems as do exist would create more harm than benefit.

Although the exchanges have recognized the potential for abuse arising from dual trading by floor brokers, in particular, they have asserted that actual violations have been few.[148] Frederick Uhlmann, Board Chairman of the Chicago Board of Trade, told the House Agriculture Committee that he could "state categorically that . . . there have been very, very few documented cases of such abuses."[149]

Several recent studies directly contradict such claims. In a 1965 report, the Comptroller General reviewed selected futures transactions on one exchange and found forty-seven instances of questionable trading practices during a three-month period.[150] In nineteen of these cases, the records indicated that floor brokers had filled customers' orders noncompetitively by taking the opposite side of the transaction either for their own account or for the account of their FCM.[151] An audit report of the Commodity Exchange Authority in 1971 also found evidence of widespread abusive trading practices.[152]

The exchanges argue that the problem must be minor because it is difficult and unprofitable for floor brokers to engage in abusive

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147. *See* notes 152, 160-62 *infra* and accompanying text. William Phelan, Director of the Investigations Office, Chicago Mercantile Exchange, has acknowledged that "[t]here's an unbelievable temptation, if the trader sees that his own account shows a loss and the customer's account shows a profit, to substitute the trades." 119 CONG. REC. S23,504 (daily ed. Dec. 20, 1973).

148. *See, e.g., 1973 House Hearings, supra* note 50, at 128-29; *House Small Business Hearings, supra* note 38, at 163, 192, 259; *1974 Senate Hearings, supra* note 37, at 521.

149. *1974 House Hearings, supra* note 44, at 163.

150. 1965 REPORT OF THE COMPTROLLER, *supra* note 108, at 11.

151. *Id.*

152. These included an excessive number of trades between brokers executing customer and house-account orders for the same firm, numerous trades between partners or members of the same firm, and trades in which the same broker represented both parties. *Id.* at 6-7, 59-67. During the period of dramatic rises in futures prices in 1973, several articles critical of futures trading regulation drew attention to allegations of unethical practices. *See, e.g.,* 119 CONG. REC. S23,502-20 (daily ed. Dec. 20, 1973); 119 CONG. REC. S11,732-34 (daily ed. Sept. 26, 1973), *quoting* Washington Star-News, Sept. 25, 1973.

practices.[153] An official of the Chicago Mercantile Exchange explained that a broker is legally responsible for executing all of his customers' orders pertaining to given futures contracts. Orders must be time-stamped when they come to the broker and again when they are returned.[154] Times can thus be checked against the exchange's record of market prices at different times.[155] If the broker fails to execute an order, or if he was negligent on the basis of what the exchange indicates the price of execution should have been, he can be held personally responsible for the customer's loss.[156] Such liability can be extensive. In addition, exchange officials assert that the severity and strict enforcement of rules prohibiting such conduct make it unlikely that floor brokers will breach their duties.[157]

Nevertheless, witnesses who have traded on futures markets have stated that abusive practices are prevalent.[158] First, they have pointed out that there is considerable doubt as to how rigorously the exchanges enforce their regulations.[159] Second, the pace and informality of futures trading create numerous opportunities for abuse.[160] Even a wink of an eye or a tug at an ear can indicate to a floor trader that he should buy from or sell to his friend, and then quickly get out of the market.[161] It may be both profitable and simple for a floor broker to abuse his dual position by trading on his own account. Because of the volatility of the markets, and the volume at which

153. *See 1973 House Hearings, supra* note 50, at 129.

154. *Id.* at 194.

155. However, there may be a long period of time between the broker's initial receipt of the order and his return of the executed order.

156. *1973 House Hearings, supra* note 50, at 194.

157. *Id.* at 129 (statement of F. Uhlmann, Chairman of the Board, Chicago Board of Trade); *1974 Senate Hearings, supra* note 37, at 331 (statement of J. Geldermann, Chairman of the Board, Chicago Mercantile Exchange).

158. *See, e.g.,* H.R. REP. No. 93-963, *supra* note 142, at 52-54; *House Small Business Hearings, supra* note 38, at 50, 58 (testimony of H. Fortes, former Vice Chairman, Chicago Mercantile Exchange); *id.* at 258-59 (statement of Special Subcommittee Counsel Jacob Gross).

159. An unidentified former official of the Chicago Board of Trade has been quoted as indicating that proposals to regulate closely the operation of scalpers have been under preparation for years. But, he asserted, "[t]hey always seem to get shot down at the end of the runway," because the Board of Directors is dominated by floor brokers, and a majority faction always votes the regulations down. 119 CONG. REC. S11,727-30 (daily ed. Sept. 26, 1973), *quoting* Washington Star-News, Sept. 24, 1973.

160. A House Subcommittee found the possibilities for abuse "so great as to stagger the imagination." H.R. REP. No. 93-963, *supra* note 142, at 53.

161. It is not even necessary that there be direct collusion. A knowledge of the habits of fellow brokers and their customers, or of their usual actions when they have large orders to fill, can enable a broker to go in and out of the market on the price movement created by a large order. Because futures markets are susceptible to sharp movements in reaction to sizeable individual orders, there is substantial temptation for a trader with knowledge of such an order to "ride the wave." *1973 House Hearings, supra* note 50, at 9-10 (testimony of Representative Smith).

floor brokers can deal, they may make tens of thousands of dollars by engaging in dual trading.[162] These potential gains make the risk of exchange discipline less menacing.

If abuses do exist, the exchanges argue, they may be controlled by exchange and federal rules and regulations, without abolishing dual trading entirely.[163] Exchange witnesses have argued that federal regulators already have the power to investigate floor brokers' activities and to issue complaints when they find violations of federal rules.[164] However, in most cases it is difficult to obtain the evidence necessary to prove a violation.[165] The problem is caused in part by the failure of some exchanges to time-stamp their orders or to record the names of customers who place orders.[166] But even if the Commission required that this information be included in the daily trading reports, it would remain impossible in many cases directly to establish collusion between brokers. For example, abuse would be particularly hard to detect in a case in which a floor broker had several orders to fill within ten seconds during a major price movement. Even strict regulations can provide no practical deterrent in such situations.

The exchanges make a compelling argument that dual trading should be preserved because it is necessary to exchange liquidity,[167] which they claim is essential to a successful market.[168] A liquid market has a sufficient supply of bids and offers, which facilitates smooth price movements and swift execution of orders.[169] Exchange officials note that a floor broker must at times assume the other side in a trade with one of his customers in order to provide the best execution of the customer's order.[170] Furthermore, they assert, the

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162. *See id.* at 10.

163. *See, e.g., 1974 Senate Hearings, supra* note 37, at 331-33, 521-22.

164. *See, e.g., 1973 House Hearings, supra* note 50, at 96 (statement of H. Christopher, President, Board of Trade of Kansas City, Missouri, Inc.).

165. H.R. REP. No. 93-438, *supra* note 62, at 53; *House Small Business Hearings, supra* note 38, at 337 (testimony of A. Caldwell, Administrator, Commodity Exchange Authority); *id.* at 306-07, (testimony of L. Greess, Acting Inspector General, U.S. Dept. of Agriculture).

166. *See* text at notes 108-39 *supra*.

167. *See, e.g., 1973 House Hearings, supra* note 50, at 71, 96, 129, 137, 164, 194; *House Small Business Hearings, supra* note 38, at 163, 214; *1974 Senate Hearings, supra* note 37, at 313, 332, 386, 522, 672.

168. *See, e.g., 1973 House Hearings, supra* note 50, at 96.

169. *See, e.g., id.; 1974 Senate Hearings, supra* note 37, at 332, 397.

170. [F]loor brokers frequently are given a large order in a specified delivery month which will require several transactions to complete. As the broker executes this order he may see that its size is causing the price in that delivery month to move out of line with prices in other delivery months. In such a situation, the broker may find that he can effect the best execution for his customer by taking the opposite side of his customer's order (with the prior consent of the customer), while taking offsetting positions in different delivery months.

1973 House Hearings, supra note 50, at 117.

market created by the trades of floor brokers allows commercial interests to fill their hedge orders without delay. This is especially important on the smaller markets, where commercial interests may account for ninety per cent of all transactions.[171] Even on the larger markets, dual trading by floor brokers allegedly adds needed flexibility.[172]

The major fallacy in this liquidity argument is that floor brokers have no obligation to trade for themselves when markets are thin. They have no responsibility to the exchange,[173] and in fact brokers are unlikely to trade in a market that is not also attractive to non-broker traders. Many feel that floor brokers trade for themselves mostly in periods of substantial customer volume.[174] A second weakness is that there is little agreement on the degree of liquidity necessary for a smoothly functioning futures market. One exchange official defined a liquid market simply as one in which a person coming to buy or sell can be confident of receiving a reasonable price,[175] because such a market will tend not to suffer from sudden fluctuations in price.[176] But this analysis overlooks the detrimental effect that personal trading by floor traders and brokers may have on the market. It is generally suspected that floor brokers trading for their own accounts concentrate more on intra-day trading, or scalping,[177] than on position trading.[178] A major SEC study of the securities markets found that "floor traders tend to have a destabilizing influence on prices. . . . [F]loor traders are generally buyers in rising markets and sellers in declining markets . . . . Their trading, as a result, is inimical to the orderly functioning of the market, tending to accentuate rather than stabilize price movements."[179]

171. *House Small Business Hearings, supra* note 38, at 225.

172. Supposedly, when volume is heavy, floor brokers fill customer orders; when volume declines, they tend to trade for their own accounts. *1973 House Hearings, supra* note 50, at 129.

173. The situation is different on the securities exchanges, where specialist brokers do have such a responsibility. *See* note 181 *infra.*

174. *See, e.g., 1974 Senate Hearings, supra* note 37, at 203, 376.

175. *Id.* at 341 (statement of J. Geldermann, Chairman of the Board, Chicago Mercantile Exchange).

176. For this reason, many feel that there can never be too much liquidity. *See, e.g., id.* at 284 (Letter of R. Richards, Vice-President, CPC International, Inc., representing the National Grain & Feed Association).

177. *See* text following note 27 *supra.* A scalper "attempt[s] to make a financial profit by entering and exiting from a market in short periods of time after a very small profit has been made." B. GOULD, DOW-JONES-IRWIN GUIDE TO COMMODITIES TRADING 351 (1973). *See also* T. HIERONYMUS, *supra* note 11, at 45-46.

178. *See, e.g.,* 1965 REPORT OF THE COMPTROLLER, *supra* note 108, at 22. Position traders hold long or short positions over a period of days, weeks, or months. *See* B. GOULD, *supra* note 177, at 350; S. KROLL & I. SHISKO, *supra* note 70, at 212.

179. SPECIAL STUDY OF SECURITIES MARKETS OF THE SECURITIES AND EXCHANGE COMMISSION, H.R. DOC. No. 95, 88th Cong., 1st Sess., pt. 2, at 240 (1963) [hereinafter SEC SPECIAL STUDY].

A similar analysis pertains to trading by floor brokers on futures markets. A floor broker has an advantage over an outsider in his ability to move in and out of markets quickly, and to make a profit on small price movements. If he sees a market trend, a broker is more likely to attempt to profit from it within one day than to tie up his capital in long-range transactions.[180] Thus, the advantage of dual trading in terms of smoothing out price movements may well be outweighed by the tendency of dual trading to encourage artificial price levels.[181]

The exchanges object to the proposed prohibition of dual trading because they fear it will precipitate an undesirable restructuring of the markets. Brokers forced to choose between serving customers and their own accounts allegedly will choose the latter.[182] This will force customers to take their business to new brokers with less experience and skill. But, if in fact most skilled brokers would choose to trade for themselves (which seems unlikely given the diverse business interests of floor brokers), the resulting shortage surely would not be permanent. The supply of customers would attract new brokers who would develop the requisite skills.

The exchanges claim that a prohibition on dual trading will have the additional undesirable consequence of discouraging speculation and will result in the domination of markets by commercial interests.[183] Recent increases in trading activity, however, suggest that

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180. *See* 1965 REPORT OF THE COMPTROLLER, *supra* note 108, at 24 (CEA investigations of practices in the September 1971 rye futures market).

181. While the available evidence suggests that liquid futures markets could function adequately without dual trading, some observers have suggested that a specialist system should be adopted by the futures markets, similar to the one that exists in the securities exchanges. *See 1974 House Hearings, supra* note 44, at 127 (testimony of A. Economou, President, American Board of Trade; President, American Association of Commodity Traders); *id.* at 189 (testimony of J. Bianco, Yale Legislative Services, Yale University Law School). Such a system seems unnecessary and unsuited to futures markets. A specialist is an exchange member who is granted permission by the exchange to trade in several specialty stocks. He executes certain orders for other brokers and is responsible for making a fair and orderly market in each specialty stock. *See* SEC SPECIAL STUDY, *supra* note 179, pt. 2, at 57-59. But securities exchanges, unlike futures exchanges, handle trades in a large number of stocks that can be divided easily among specialists. On a futures exchange, the volume of trading in one contract will often be too large for any one broker to handle, while in another contract there may not be enough activity to sustain a broker. *See 1974 Senate Hearings, supra* note 37, at 342 (statement of J. Geldermann, Chairman of the Board, Chicago Mercantile Exchange). Furthermore, a specialist on a securities exchange is given a virtual monopoly, which can be extremely lucrative. Unless such a system is absolutely necessary to maintain liquidity on futures exchanges, its anticompetitive effects make its adoption undesirable. *Cf.* Pozen, *Competition and Regulation in the Stock Markets*, 73 MICH. L. REV. 317 (1975).

182. *See, e.g., 1973 House Hearings, supra* note 50, at 129; *1974 Senate Hearings, supra* note 37, at 275.

183. The reasons for this would be twofold. First, a forced separation of functions would result in less total speculative activity by brokers. Second, some of those speculators whose brokers become only floor traders may not enter the market because of lack of confidence in other brokers. *1974 House Hearings, supra* note 44, at 106-07 (testi-

substantial speculation in these markets will continue whether or not dual trading is banned.[184] As long as many commodities remain scarce, and prices remain high, it is unlikely that speculators will lose their interest in the futures markets. Moreover, a decrease in speculation might not be unwelcome. Although some speculation is necessary to maintain liquidity, many analysts feel that excessive speculation may add to artificial price levels and thus distort the markets.[185] Moreover, the markets are useful primarily because they serve commercial interests, and a more dominant position for these interests might be a beneficial side effect of prohibiting dual trading.[186]

A more troubling objection is that a ban on dual trading might substantially weaken the smaller exchanges and deter the formation of new exchanges.[187] While the dangers of dual trading on the large exchanges seem to outweigh the benefits, the equation may change if a ban would jeopardize the existence of smaller exchanges. One might answer that exchanges that cannot survive under a ban on dual trading are not economically viable, and should be allowed to collapse.[188] However, the flexibility and competitive pressure brought about when larger numbers of markets trade in the same contracts are advantages that should not be dismissed lightly. Furthermore, on small markets it is easier to monitor broker practices for possible abuses. The Commission thus might make an exception for exchanges with a trade volume below a certain level. It could determine at what volume there is sufficient liquidity to absorb a ban on trades for brokers' own accounts without creating severe instability. This solution was proposed in Congress,[189] and the emphasis in the 1974 Act on maintaining liquidity seems to justify its adoption by the Commission.

Finally, it could be argued that an absolute prohibition on dual

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mony of L. Melamed, Chairman, Chicago Mercantile Exchange); *id.* at 165 (testimony of F. Uhlmann, Chairman, Chicago Board of Trade).

184. For statistics on the recent growth in futures trading, see *1974 Senate Hearings, supra* note 37, at 543-47 (attachments to statement of J. Clagett, President, Association of Commodity Exchange Firms, Inc., New York, N.Y.).

185. *See* text accompanying notes 178-81 *supra.*

186. Futures markets have developed into a means of providing commercial interests with a way to transfer risk to those willing to assume it. Therefore, while speculators are needed, so long as there are sufficient numbers of them to facilitate hedging, domination of the market by commercial interests is not objectionable.

187. *See, e.g., 1974 House Hearings, supra* note 44, at 17 (statement of Dr. C. Yeutter, Assistant Secretary for Marketing and Consumer Services, U.S. Dept. of Agriculture); *1974 Senate Hearings, supra* note 37, at 386-87 (testimony of A. Donahoo, Executive Vice-President, Minneapolis Grain Exchange); *id.* at 738 (testimony of R. Schotland, Professor of Law, Georgetown University Law Center).

188. *See, e.g., 1974 Senate Hearings, supra* note 37, at 686 (testimony of G. Clark, Professor of Law, Drake University Law School).

189. *See* S. 2837, 93d Cong., 1st Sess. § 308 (1973).

trading by floor brokers might prevent them from correcting orders that either were not executed or were inaccurately executed.[190] A floor broker must assume the risk of error in filling his customer's order;[191] he must make the customer's order good, either by paying the difference between what the customer earned from the erroneous transaction and what the customer would have earned had his order been executed correctly, or by carrying out a proper reexecution. Even if brokers would continue to bear the financial burden of incorrect execution under a ban on dual trading, the ban would make it more difficult for a customer to obtain his desired contract because the broker could not rectify the mistake by trading for his own account with the customer, as is done under the current system. Moreover, the broker would bear a greater potential risk because he would be dependent on others to execute the correcting order, which will determine the extent of his liability for the original mistake. If, on the other hand, the ban precipitates a shift in liability for the error to the clearing firm or the customer, the result could be less attention to the execution of orders and higher costs to the customer.[192] Therefore, an exception probably should be made in a Commission ban on dual trading to allow brokers to enter the market under carefully circumscribed conditions to rectify their errors in executing customer orders.

Although there are many differences between futures markets and securities markets, it is useful to note that the Securities and Exchange Commission has long been concerned with the abuses fostered by dual trading.[193] A 1963 SEC study of the securities markets found that regulation of dual trading at that time was inadequate.[194] The study contended that the privilege of access to the trading floor was a substantial advantage; the trader was able to observe trading activity at close range, thus developing a "feel" for the market, and could enter and exit in a matter of seconds. Similar advantages accrue to floor brokers on futures exchanges. Furthermore, securities futures brokers trading for their own accounts may avoid the standard commission costs, by executing either for themselves or through other floor brokers.[195] These advantages of access to the trading floor place the retail customer at a competitive dis-

190. *See, e.g., 1973 House Hearings, supra* note 50, at 67 (letter from F. Corrigan, Peavey Co., Minneapolis, Minn., to W.R. Poage, Chairman, House Comm. on Agriculture); *id.* at 195 (statement of L. Melamed, Chairman, Chicago Mercantile Exchange).

191. *See* text at note 156 *supra.*

192. *1973 House Hearings, supra* note 50, at 195 (statement of L. Melamed, Secretary, Chicago Mercantile Exchange).

193. *See* SEC SPECIAL STUDY, *supra* note 179, pt. 2, at 238-42.

194. *Id.*

195. *See* 1965 REPORT OF THE COMPTROLLER, *supra* note 108, at 23.

advantage, and can be eliminated only by prohibiting dual trading, as the securities study strongly recommended.[196]

The objections to dual trading by floor brokers discussed above apply similarly to dual trading by futures commission merchants. An FCM may maintain a house account, and may trade for itself at the same time that it advises customers and solicits or fills customer orders. Many FCM's allow their account executives[197] to maintain personal trading accounts, which the executives manage in addition to clients' accounts. Because a large order can have a significant impact on trading in a particular futures contract, a potential conflict of interest arises whenever an FCM holds a position in the same commodity. Furthermore, in periods of heavy trading a floor trader may be tempted to neglect his client's position in favor of trading for himself. A ban on FCM trading for personal accounts would prevent both these conflicts from arising.[198]

Prohibiting dual trading would also prevent FCM's from making unfair use of inside information. Although exchange officials contend that inside information is not a major problem on the futures markets,[199] the ready access of FCM's to market information gives them a competitive edge over retail customers. Although FCM's have no better access to highly confidential information, such as government commodity reports, they do receive much useful information through informal interchanges on and near the exchange floors.

Some observers argue that customers prefer to deal with an FCM who is a market trader. Personal trading supposedly gives the FCM a better feel for the market; if an FCM risks his (or its) own money, his recommendations will carry more weight.[200] However, responsible FCM's should stay closely attuned to the markets whether or not they are personally involved in trading. Furthermore, FCM's who trade for their own accounts need not communicate their best strategies to their customers.

If the weight of the arguments on this issue had been clear, Congress probably would not have delegated the decision to the

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196. SEC SPECIAL STUDY, *supra* note 179, pt. 2, at 241-42.

197. An account executive is commonly known as a "broker."

198. It is interesting to note that two of the largest commission houses are so concerned by this problem that they will not allow their salesmen or other employees to trade on futures markets; nor will they deal with brokers who trade for their own accounts as well as for their customers. Interview with Paul H. Franklin, Jr., Director of Commodity Division, Merrill Lynch, Pierce, Fenner & Smith, Inc., in New York, N.Y., Aug. 10, 1973 (memorandum of interview on file with the *Michigan Law Review*); Interview with Robert L. Raclin, Vice-President, Paine, Webber, Jackson & Curtis, in Chicago, Ill., Aug. 17, 1973 (memorandum of interview on file with the *Michigan Law Review*).

199. *See, e.g., 1974 Senate Hearings, supra* note 37, at 313 (testimony of C. Bradley, President, The Board of Trade of Kansas City, Mo., Inc.).

200. *1974 House Hearings, supra* note 50, at 57 (testimony of M. Maduff, Maduff & Sons, Chicago, Ill.); *1974 Senate Hearings, supra* note 37, at 713.

Commission. Uncertainty, however, should not indicate that a compromise is the best solution. Compromise is dangerous in the area of ethical market conduct; if futures markets are to be fair, and if public confidence in them is to be achieved, every taint of abusive practices must be eliminated. Dual trading should thus be prohibited, with the exceptions discussed above.

D. *Computerized Trading*

During the hearings on the 1974 Act, Congress received testimony on proposals to computerize the entire futures trading system.[201] Under these proposals, all buy and sell orders would be matched electronically by an exchange computer. Although this system could largely eliminate the problems of inadequate daily trading information and floor trading abuses discussed above,[202] Congress apparently concluded that the idea did not currently warrant legislative action. However, the new Act does require that the Commission conduct ongoing research into computerized trading.[203] No time limit is set on this study, nor is there a provision for later reports to congressional committees. Unless the newly appointed Commissioners give priority to this issue, therefore, a decision on whether to encourage computerization could be postponed indefinitely. The discussion below will center upon the potential advantages of computerized trading, and indicate why objections to it are unpersuasive.

Under the current system,[204] the chaos of the marketplace sometimes prevents orders from being filled in the sequence in which they are received.[205] Moreover, at a given moment prices may vary within a pit for the same contract on the same commodity,[206] because brokers in the pit sometimes cannot hear each other's bids above the din of the trading floor. An electronic system would alleviate these problems because it would permit trading in an orderly manner. Such a system would replace floor trading. Buy and sell orders would be fed into a computer, which would match the orders automatically.[207] An accurate record of daily trading, includ-

201. *See, e.g., 1974 Senate Hearings, supra* note 37, at 244-47, 253-54.

202. *See* text at notes 108-200 *supra*.

203. Pub. L. No. 93-463, § 416, 88 Stat. 1415 (1974).

204. The essentials of the present trading system developed during the middle of the nineteenth century. *See generally* CHICAGO BOARD OF TRADE, COMMODITY TRADING MANUAL 1-12 (1973); T. HIERONYMUS, *supra* note 11, at 69-91; H. IRWIN, EVOLUTION OF FUTURES TRADING (1st ed. 1954). Today the exchanges have a far larger volume and different trading problems, but their trading system has not changed substantially. *See 1974 Senate Hearings, supra* note 37, at 352.

205. *See id.* at 253.

206. *Id.*

207. *House Small Business Hearings, supra* note 38, at 340; Johnson Interview, *supra* note 12.

ing the names of actual traders, could easily be provided to federal regulators.[208] If market manipulation were suspected, the pattern of trading could be quickly and accurately reconstructed.

Computerization would end the potential abuses of dual trading.[209] Collusion and careful mutual timing of trades would be more difficult in a computerized system. Moreover, such a system would protect customers from the inequities that would remain possible even if the Commission were to prohibit dual trading. Even under a ban, floor traders might enter into advantageous schemes with brokers.[210] For example, a broker on the exchange floor might signal a floor trader of his intention to place a large order, in return for a percentage of the floor trader's profits attributable to the tip. On an electronic market, such schemes would be more difficult to execute, because of uncertainties in timing.

Finally, a computerized system would lessen the influence of rumors on the futures markets.[211] Rumors circulating on the exchange floor presently can have a decided effect on trading. If floor traders, on the basis of their "feel" for the market, believe that trading is moving in a certain direction, they will quickly buy in and out, thereby accentuating the trend.[212] A computerized market could not accommodate trades at a frantic pace because of technological limits, and would thus force traders to wait a few moments between trades. This waiting period would make wild price movements less likely.[213]

The idea of a computerized market has met strong opposition from established traders and institutions.[214] A common objection is that computerized trading is not technologically feasible. Even the exchanges are divided on this argument,[215] however, and insufficient data are available to resolve the issue conclusively. Officials of the Chicago Board of Trade have cited a study of computerized trading made for the new Pacific Commodities Exchange that showed that it would be technologically feasible, but economically impractical, to develop such a system.[216] Federal regulatory authorities also

208. *See* FUTURES DATA REPORT, *supra* note 113, at 86.

209. *See* text at notes 140-200 *supra.*

210. *See, e.g., 1974 Senate Hearings, supra* note 37, at 204 (statement of Senator Clark).

211. *Id.*

212. *See* text at notes 178-80 *supra.*

213. *See* H.R. REP. No. 93-963, *supra* note 142, at 59-60.

214. *See, e.g., 1973 House Hearings, supra* note 50, at 70, 95, 116, 190; *House Small Business Hearings, supra* note 38, at 162; *1974 Senate Hearings, supra* note 37, at 310, 351-52.

215. *Compare 1974 Senate Hearings, supra* note 37, at 310, 351, *with 1973 House Hearings, supra* note 50, at 127.

216. *1973 House Hearings, supra* note 50, at 127 (testimony of F. Uhlmann, Chairman of the Board, Chicago Board of Trade).

believe that a computerized system is possible,[217] but they cannot predict the cost of a system without further studies.[218] Complicating the lack of data is the forecast that the burden of adopting a computerized system would be heaviest on the less affluent, smaller exchanges.[219]

Some exchanges suggest that no action be taken until the securities markets adopt a computerized system.[220] Those markets then will have assumed the financial burden of the technological development, and the futures exchanges would need only absorb the cost of adapting the system to fit their own needs. But delaying the decision in this manner has disadvantages. Futures markets differ substantially from securities markets, and the adaptation process might be difficult and time-consuming. Furthermore, immediate and pressing problems pervade the futures markets,[221] and delay in solving them might in the long run be more costly than immediate action.

There are three ways to reduce the costs to the exchanges of developing a computerized system. First, the Commission could encourage the exchanges to pool their resources and develop a joint system. Second, the Commission could request federal appropriations. Given the advantages of a computerized system for effective regulation, and the likelihood that the exchanges will not take the initiative in this area, the federal government should perhaps sponsor the necessary development. Finally, the securities and the futures exchanges could cooperate in developing the necessary technology.

Many exchange officials are concerned that even if all of the technological and economic obstacles could be overcome, a computer system would not adequately safeguard the information it would contain.[222] Much trading data is already filed with clearing houses on the larger exchanges, however, and this system has not caused any major problems.[223] If the detailed recommendations of

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217. *See, e.g., 1974 Senate Hearings, supra* note 37, at 253 (testimony of A. Caldwell, Administrator, Commodity Exchange Authority).

218. *See* the recommendations for further study in FUTURES DATA REPORT, *supra* note 113, at 85-86.

219. *See, e.g., 1973 House Hearings, supra* note 50, at 70 (testimony of A. Donahoo, Secretary, Minneapolis Grain Exchange, Minneapolis, Minn.).

220. *See, e.g., id.* at 116 (testimony of R. Clark, representing the New York Coffee & Sugar Exchange, Inc., The Commodity Exchange, Inc., and the New York Cocoa Exchange, Inc.).

221. *See, e.g.,* text at notes 205-13 *supra.*

222. *See, e.g., 1974 Senate Hearings, supra* note 37, at 310 (testimony of W. Vernon, III, Executive Vice-President, Board of Trade of Kansas City, Mo., Inc.). One exchange official asserted that the possibilities of unauthorized access to data systems "stagger the imagination . . . ." *Id.*

223. *See* T. HIERONYMUS, *supra* note 11, at 40-43; *House Small Business Hearings, supra* note 38, at 198-202 (testimony of R. Westley, Chairman of the Board of Governors, Board of Trade Clearing Corp.).

the Joint USDA-Industry Study Team on Futures Trading Data Systems are adopted, the data reporting and storage arrangement would be highly mechanized. The Study Team concluded that such a system would adequately protect confidentiality.[224]

It has been argued that trading from remote computer terminals would make it difficult to investigate the financial status of one's trading partners.[225] But even under present trading conditions, floor traders often do not know the identity or financial status of the other party. Moreover, the computerized system could screen participants, as is done now in deciding who will be allowed to trade on the exchange floors.[226]

Another criticism relates to the ability of computers to allow for rapid correction of trading errors and withdrawal of bids and offers.[227] The necessity of placing orders through terminals limits somewhat the ability of traders to reverse trading directions quickly. The present federal administrator, however, has claimed that a computerized system could be made practical in this respect.[228] One possibility would be to allow orders to be withdrawn only if they have not been immediately matched. This might decrease market flexibility, but it would encourage traders to give closer attention to each trade. This solution might actually have a positive effect on market stability, by making rapid speculative trading more difficult.

A final and more basic objection to computerization stresses the human element, which supposedly makes markets more responsive to users.[229] Brokers use intuition and judgment in bargaining for their customers, intangibles that will be less important in an electronic marketplace. A mechanical system that matches orders without offering an opportunity to examine offers or bids on the spot reduces flexibility, according to some.

Individual brokers do try to get the "feel" of the market, and they adjust their actions accordingly. Indeed, a House subcommittee found that some futures traders pay little attention to the factors of supply and demand that theoretically shape market behavior. They are influenced instead by the attitudes of other speculators; if the belief develops in a pit that the market will go up, many traders

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224. *See* FUTURES DATA REPORT, *supra* note 113, at xii, 3, 17-18, 32, 52, 58.

225. *See 1974 Senate Hearings, supra* note 37, at 310 (testimony of W. Vernon, III, Executive Vice-President, Board of Trade of Kansas City, Mo., Inc.).

226. *E.g.*, RULES AND REGULATIONS OF THE BOARD OF TRADE OF THE CITY OF CHICAGO, ch. 4, ch. 9, § 259 (1973).

227. *See 1973 House Hearings, supra* note 50, at 70 (testimony of A. Donahoo, Secretary, Minneapolis Grain Exchange, Minneapolis, Minn.).

228. *See 1974 Senate Hearings, supra* note 37, at 253 (testimony of A. Caldwell, Administrator, Commodity Exchange Authority).

229. *See 1973 House Hearings, supra* note 50, at 128 (testimony of F. Uhlmann, Chairman of the Board, Chicago Board of Trade); *id.* at 190 (testimony of M. Weinberg, Chairman of the Board, Chicago Mercantile Exchange).

will buy, thus stimulating an artificial upward movement.[230] Many of these judgments are economically unsound, and of little benefit either to the market or to the economy. Some subjective assessments are valuable, but they could continue to play a role in a computerized system. Brokers would have to judge the market from a distance, but this should put a premium on ability to evaluate supply and demand, government reports, and the many other elements that shape market trends, rather than discouraging reliance on such factors.[231]

Of course, computerized markets would lack the color and excitement of a pit full of frantic traders. But the futures markets play too important a role in our economy to ignore changes that may increase their effectiveness. Computerization might help to restore public confidence in markets that have been charged repeatedly with fostering abusive practices. In addition, the use of computers might aid in stabilizing prices and systematizing trades. These possibilities make at least the study of computerization immediately important.[232]

V. Problems Not Considered in the 1974 Legislation

Although the 1974 Act effects many major reforms, it fails to provide the new Commission with the authority to deal with two troublesome problems—the market distortions that may be caused when foreigners make sizeable trades on American exchanges, and the extent to which federal control should be exerted over margin requirements. Perhaps it was felt that these issues were beyond the scope of the Commission's regulatory powers.[233] The discussion below will examine the importance of these problems and assess the role that the Commission could play in dealing with them.

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230. H.R. Rep. No. 93-963, *supra* note 142, at 59.

231. There would still be considerable advantages for brokers located near a board of trade, where they would have ready access to other traders and could keep close track of market movements. However, these advantages would be of less importance than they are in the current system, and the gap between those trading on the floor and those located elsewhere would be less conspicuous. *See* Futures Data Report, *supra* note 113, at 86.

232. *See generally* H.R. Rep. No. 93-963, *supra* note 142, at 59-60 (conclusion of the Subcomm. on Special Small Business Problems, Permanent Select Comm. on Small Business, favoring computerized trading). *See also* Futures Data Report, *supra* note 113, at 85-86. Paul Franklin, Vice-President and Director of Commodites of Merrill Lynch, adds, "computerization is inevitable. If the Commission acts in an objective and knowledgeable way, commodities trading can only benefit." Bus. Week, Dec. 21, 1974, at 145. *See also* UNCTAD Study, *supra* note 33, ¶ 42.

233. Many feel that the issue of export controls involves the country's over-all agricultural policy, and not just the functioning of the futures markets. In contrast, it has been argued that margin controls can best be dealt with at the exchange level, rather than at the governmental level. *See* text at notes 263-315 *infra*.

A. *Export Controls*

Few incidents involving the agricultural sector of the American economy have occasioned as much popular criticism and alarm as the so-called "Russian wheat deal" of 1973.[234] The deal involved the sale of huge amounts of grain to the Soviet Union, and helped to drive wheat prices on futures markets to unprecedented levels.[235] The concern over the wheat trade contributed to the increased congressional interest in futures markets that led to the 1974 Act.[236] Yet, the Act gives the Commission little authority to guard against the disruptive effects that such foreign trades can have on American futures markets.

The omission reflects, in part, a determination that the futures markets were not solely responsible for whatever errors were made in allowing the wheat deal to occur. Once the sale had been made, much of the damage had already been done; the prices on the futures markets simply reflected the new supply and demand situation on the cash market. But the futures markets remain crucial to successful negotiations between American companies and large foreign buyers of American commodities.[237] Moreover, the intent of Congress in adopting the 1974 Act was to ensure "fair practice and honest dealing on the commodity exchanges," and to provide "a measure of control over those forms of speculative activity which often demoralize the markets to the injury of producers, consumers, and the exchanges themselves."[238] As will be demonstrated, without control over the access of large foreign traders to American markets, or control of American exporters that attempt to hedge large orders, the Commission often will be unable to pursue its mandate.

Large export transactions with foreign governments or companies pose two problems. The first is the potential for foreign manipulation of American markets. Presently, foreign companies and governments are as free as domestic traders to take speculative positions on American futures markets. They are subject only to the limits on speculation that are imposed by federal authorities on American trading firms.[239] However, unlike domestic traders, foreign traders may speculate indirectly, and thereby avoid these re-

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234. For a general description of the chronology of this incident, and its impact, see J. TRAGER, AMBER WAVES OF GRAIN (1st ed. 1973).

235. *See* BUS. WEEK, Aug. 4, 1973, at 46; New York Times, Oct. 15, 1973, at 58, col. 1 (late city ed.).

236. *See 1974 House Hearings*, *supra* note 44, at 21 (testimony of Dr. C. Yeutter, Assistant Secretary for Marketing and Consumer Services, U.S. Dept. of Agriculture).

237. *See* H.R. REP. No. 93-963, *supra* note 142, at 31-36.

238. S. REP. No. 93-1131, *supra* note 62, at 1.

239. For example, the maximum net long or net short position that any person may hold in any one grain on any contract market is 2 million bushels. 7 U.S.C. § 6a (1970); 17 C.F.R. § 150 (1974).

quirements, because federal authorities have inadequate information to determine in advance whether the foreign customer really intends to export all of the cash commodity he purchases, or whether he intends to use it for speculation. Thus, a foreign country can buy more of the cash commodity than it actually needs for its own consumption and hold the excess in American storage facilities until the price has risen. It can then sell the excess on the cash market, often at a price high enough to pay for the entire initial purchase.[240] The cash price may drop, of course, but the foreign buyer can hedge by taking a long position on the futures markets. When the futures sellers discharge their obligation, little of the commodity will be available on the cash market, so prices will have risen substantially.

Another, more complicated scheme allows large foreign traders to profit from market distortions by taking a short rather than a long position on the futures markets.[241] A foreign company or country could first purchase extra inventory of a commodity. After waiting for the increase in futures prices that would reflect the shortage on the cash market, it could hedge its inventory by selling short—that is, by buying contracts to sell—at the prevailing high price. It could then release its excess commodity for general sale, which would drive futures prices down. Subsequent liquidation of its short position would yield a substantial profit.

The consequences of such manipulation could be far more serious than even the consequences of the Russian wheat deal.[242] Congressman Neal Smith noted that

> what happened is not the worst that can happen. There are other dangers lurking around the corner, and we ought to be thinking about these things before they are upon us. One of them that apparently we really have not been giving enough attention to is the possibility that some company, or some foreign country indirectly through a company could really distort our grain market more than all the other speculators we are worried about could possibly do.[243]

The Commission might request several powers that would enable it to deal with these problems. An extreme proposal by an official of one large export company would ban foreign governments from hedging on American futures markets.[244] The official argued

240. The House Small Business Subcommittee investigating futures markets estimated that a foreign party could take delivery of only one quarter of a big purchase and make enough profit from the resale of the rest to pay for the grain that is actually exported and consumed. H.R. REP. No. 93-963, *supra* note 142, at 35.

241. *See House Small Business Hearings, supra* note 38, at 378.

242. *See id.* at 377.

243. *Id.*

244. *1973 House Hearings, supra* note 50, at 178 (statement of W. Saunders, Group Vice-President, Cargill, Inc., Washington, D.C.).

that, since foreign governments supposedly acquire commodities only for direct consumption, they should not need to hedge their inventories. Foreign governments would then be subject to the speculative trading limits on all of their transactions, and there would be no possibility of massive price manipulation. While such a solution would be easy to enforce, it would place foreign interests at a significant disadvantage on American markets. The American futures markets play a central role in the determination of world prices in many commodities, and it is desirable to keep them as open as possible. Before imposing such a stringent restriction on foreign interests, the Congress and the Commission should explore less onerous controls.

The Commission must be able to ensure that foreign parties that trade on American futures markets will abide by the same limitations that are imposed on domestic traders. One mild measure would be to require that an FCM trading for a foreign party secure from it a signed document stating that it is aware of the limits on speculation and agrees to abide by them.[245] Such a document, however, would have little effect on those intent on avoiding the restraints.

A more effective approach was suggested in an amendment to the 1974 Act proposed by Senator Clark of Iowa. Clark's amendment, rejected by the Senate Agriculture Committee, would have required that an FCM trading for a foreign party obtain from the party a surety bond in an amount set by the Commission before any order to purchase or sell a futures contract could be accepted.[246] The bond would be forfeited to the United States if the foreign party failed to submit to the jurisdiction of the American courts, the Commission, or an exchange in an action to enforce the 1974 Act. The Commission would be free to waive the bond when a foreign trader's over-all position fell below a fairly substantial dollar amount. If the bond were sufficiently high, its requirement would assure the cooperation of foreign parties with domestic trading regulations without seriously restricting their access to American markets.

The Clark proposal would in no way compromise the confidentiality that foreign traders desire. The bond would not even have to be posted until after the completion of the cash transaction, when the seller might need to hedge. Moreover, the FCM could execute the bond confidentially, so that others would not become aware of the trader's speculative or hedging position. Foreign traders would undoubtedly consider the bond requirement annoying, but if

245. Interview with Robert L. Raclin, Vice-President, Paine, Webber, Jackson & Curtis, in Chicago, Ill., Nov. 7, 1974 (memorandum of conversation on file with the *Michigan Law Review*) [hereinafter Raclin Interview].

246. The proposed amendment was identical to S. 2837, 93d Cong., 1st Sess. § 303(b) (1974).

they were taking a legitimate futures position, it would be only a formality for them. The importance of securing adherence to trading regulations, without endangering the ready accessibility of American markets to foreign traders, should prompt the Commission to urge Congress to reconsider the Clark proposal.

Foreign manipulation of American markets is only one of the dangers of noncontrolled large export trading. The second danger is disguised speculation by foreign interests, which is made possible by the hedging of American grain companies and exporters. When a foreign country (perhaps represented by a large foreign company) wants American wheat,[247] it will usually contract to buy it at a fixed price with one or more American grain export companies. The export firms are willing to sell at a fixed price for future delivery because they can hedge their sales on the futures markets[248] by buying futures contracts that mature at the same time the grain is to be exported. There is no limit on the amount of futures that a company may buy, as long as the purchases are for legitimate hedging.

The Russian wheat deal is illustrative. Once the original sales contracts were made, participating American companies quickly moved into the futures markets to cover their price position, and into the cash market to contract for the actual grain.[249] They were able to do so at prices that had not yet been affected by the news of the Russian deal. As the extent of the sales became known, the value of the wheat not already under contract increased, and both cash and futures price levels rose dramatically. Those who were unaware of the deal suffered the losses, while the participating grain companies profited.[250]

The attractiveness to foreign interests of agreements with American export firms is based in large part on the firms' willingness to agree to fixed prices for future delivery. This willingness is possible only because the firms can hedge their prices on the futures markets. Even though the foreign party does not itself enter the futures market, and even though the price distortion is caused by hedging rather than by speculation, the need for regulation in this area is clear. Current efforts at control have been based on agricultural policy considerations that transcend impact on the futures markets. While the problem does go beyond the markets, it is imperative that the Commission have an input into policy determinations in the export area.

The most dramatic means of regulating foreign speculation

247. To simplify discussion, this section will refer only to wheat. Similar export sales, of course, could be made in most commodities in which futures contracts are traded.

248. *See* H.R. REP. No. 93-963, *supra* note 142, at 31.

249. *1973 House Hearings*, *supra* note 50, at 13 (testimony of Representative Smith).

250. H.R. REP. No. 93-963, *supra* note 142, at 35.

would be to impose either rigid export controls, with quotas for each nation that wants to buy American products, or floating export controls, which vary each year with the size of the crops.[251] The foreign and domestic policy ramifications of such proposals are beyond the scope of this note. The implication for the futures markets would be to limit foreign interests to the amount of each commodity needed for consumption. The controls would deter foreign groups from leaving a portion of the commodities they purchase in this country for later speculation. Furthermore, since the maximum amount of each nation's purchase would be public knowledge, each exporter would have a better idea of how much foreign interests were buying from other companies. American hedgers would thus be better apprised of the supply and demand factors likely to influence futures prices.[252]

There has been considerable opposition to the establishment of controls, from both private interests and public officials. Negotiations between foreign buyers and large American grain companies are extremely delicate. The grain companies fear that a requirement to report major agreements with foreign parties would dissuade those parties from purchasing grain in this country.[253] Agricultural exports are an important source of balance of payments income,[254] and few wish to jeopardize them. However, the consequences of market disruption or distortion, such as the 1973 rise in price levels caused in part by the Russian grain deal, are also grave. When markets are distorted by enormous foreign sales, many may demand that the government impose controls by fiat, or close the futures markets entirely.[255] Such actions would wreak havoc with the free market system and reduce foreign confidence in the ability of American firms to honor their sales agreements.[256]

251. Floating export controls have been proposed by Robert L. Raclin. Raclin Interview, *supra* note 245.

252. The Subcommittee on Special Small Business Problems of the House Select Committee on Small Business concluded that the lack of knowledge by each export firm of the extent of other Russian grain purchases, and the length of time before the users of futures markets became aware of the dimensions of the deal, enabled the Russians to buy at low price levels and thus to transfer much of the cost of the deal to other traders. H.R. REP. No. 93-963, *supra* note 142, at 31-36.

253. *See, e.g., 1974 Senate Hearings, supra* note 37, at 605-06 (testimony of C. Roberts, Jr., Vice-President, and R. Johnson, Manager, Public Affairs Department, Cargill, Inc., Minneapolis, Minn.).

254. *See House Small Business Hearings, supra* note 38, at 127 (testimony of J. Spicola, Group Vice-President, Cargill, Inc., Minneapolis, Minn.). It has been estimated that foreign sales of American commodities alone total $21.3 billion. FORBES, Dec. 15, 1974, at 66.

255. *See 1973 House Hearings, supra* note 50, at 13 (statement of Representative Smith).

256. In arguing against export controls, the President of the Chicago Board of Trade points out that "[e]xport controls send false signals to producers and consumers. They are a disincentive to more production and an incentive for more con-

Reporting requirements offer a less drastic measure with which to combat disguised speculation by foreign interests. The present administration has shortened the period for voluntary reporting of export sales three times since the Russian wheat deal.[257] Despite the objection of export firms that a reporting requirement soon after sales would drive away their business,[258] the administration has now requested firms to report advance sales over a minimum size to the Secretary of Agriculture.[259] While insisting that the reports are voluntary, the Secretary has indicated that lack of cooperation by firms would result in mandatory controls.[260] A major weakness of this informal system is that it does not provide for prompt sharing of trading information with the Commission. It is essential that the Commission have access to such information, and that it have a voice in deciding which foreign sales will be approved. Also, the quality of information could be improved if Congress were to adopt a measure similar to that proposed by Senator Clark to the Senate Agriculture Committee in 1974. The Clark amendment would have required export firms to report to the Commission the "initiation, completion, or termination" of any negotiations with foreign parties.[261] Such a strict requirement, rejected by the Committee, would have given federal authorities more time to study the effect

sumption." Because of recent ad hoc controls, he asserts, "[w]e are in danger of losing valuable markets and foreign currency." FORBES, Dec. 15, 1974, at 66.

257. *See* N.Y. Times, Oct. 8, 1974, at 1, col. 8 (late city ed.).

258. *See, e.g., 1974 Senate Hearings, supra* note 37, at 605-06 (testimony of C. Roberts, Public Affairs Dept., Cargill, Inc., Minneapolis, Minn.).

259. The current "volunteer" plan asks grain companies to report in advance proposed sales of 50,000 or more tons of grain or soybeans, as well as cumulative sales to one country that exceed 110,000 tons per week. N.Y. Times, Oct. 8, 1974, at 1, col. 8 (late city ed.); *id.*, Oct. 9, 1974, at 55, col. 8 (late city ed.).

260. *See* N.Y. Times, Oct. 8, 1974, at 1, col. 8 (late city ed.).

261. The text of the amendment, similar in intent to S. 2837, 93d Cong., 1st Sess. § 209 (1974), is as follows:

> Section 216: The Commodity Exchange Act, as amended, is amended by inserting the following new section immediately after Section 4g (7 U.S.C. 6g):
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> Section 4h. (a) Any person who negotiates to buy or sell goods, articles, services, rights or interests which may have an extraordinary impact on the futures market from sellers or to buyers outside the United States, respectively, which are the subject matter of a futures contract traded in the United States, shall file an exporter-importer report with the Commission upon the initiation, completion, or termination of any negotiations with a person outside the United States relating to the purchase or sale of such goods, articles, services, rights or interests. The reports shall contain such information and be filed in the form and manner the Commission prescribes. The Commission may require any subsequent reports under this section necessary to update the information in the exporter-importer report.
>
> (b) The Commission shall, by rule, designate the amount of an import or export which may have an extraordinary impact on futures markets.
>
> (c) The Commission shall obtain the information specified in subsection (a) from other federal agencies to the extent it is available from them.
>
> (d) Names of individual companies shall be confidential and no other information regarding the import or export may be made public until negotiations are completed.

on the market of large foreign trades, and greater flexibility in deciding what measures to take to protect the futures markets. If Commission officials did receive the information called for in the Clark amendment, they could make a prompt announcement of large sales to foreign interests. The time at which knowledge of such sales is made public is crucial in terms of market impact. While disclosure of negotiations prior to the completion of the contract would make trading difficult, and should be prohibited, prompt announcement of the sale would severely curtail the amount of hedging that would be possible at low prices. Export firms probably would respond by limiting the amount of physical commodities they would be willing to sell for future delivery at fixed prices.

The failure to give the Commission authority to deal with the impact of foreign sales on futures markets is a major flaw in the 1974 Act. At the very least, the Commission should have access to the voluntary reports presently received by the Secretary of Agriculture. More importantly, the present system should be made mandatory, and an amendment requiring reporting to the Commission should be enacted. In addition, the Commission's ability to ensure stable markets would be increased if it were allowed to make the reports public when it determines that disclosure would be in the public interest.[262]

B. *Oversight of Margins*

A "margin" is the amount that a trader buying a particular contract is required to deposit with his futures commission merchant for ultimate deposit with the clearing house.[263] It is similar to an earnest money payment, which serves as an indication of the good faith of the purchaser. Low margins are attractive to traders because they can establish a larger market position with less capital. The minimum amount of margin that is acceptable on each contract is set as often as once a day by the exchange on which the contract is bought, on the basis of the previous day's prices.[264]

Questions at the center of the debate over regulation of futures markets have been whether the federal government should oversee the setting of margins, and whether it should have the power to change margins in certain emergency situations.[265] The 1974 Act

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262. *See* S. 2837, 93d Cong., 1st Sess. § 209(d) (1974).

263. *See* T. HIERONYMUS, *supra* note 11, at 62-65.

264. *Id.*

265. *See, e.g., Hearings To Amend the Commodity Exchange Act Before the House Comm. on Agriculture,* 90th Cong., 1st Sess. (1967) [hereinafter *1967 House Hearings*]; *Hearings on the Anti-Inflation Program as Recommended in the President's Message of November 17, 1947 Before the Joint Comm. on the Economic Report,* 79th Cong., 1st Sess. (1948).

apparently denies the Commission any such authority,[266] and thus leaves the individual exchanges, in exclusive control of the setting of margins.[267] There are persuasive reasons why this approach is unwise and unworkable. This section will argue that Congress, swayed by determined and vocal opposition to federal oversight of margins,[268] overlooked several ways to delegate limited supervisory authority to the Commission without lessening the day-to-day freedom of the exchanges to determine margin levels.

As noted above, a margin payment is a deposit, given by a trader to his futures commission merchant as "earnest money." The exchanges establish a minimum acceptable margin, although the individual FCM may decide to require more in particular cases.[269] The deposit guarantees that the trader will fulfill his obligations under the futures contract. Margins are especially important in the futures market because most investors have no intention of buying the actual commodity; they contract only to buy or to sell a specified amount of the commodity at a certain time in the future.[270] Since the purpose of the margin is to assure the broker that he will be able to liquidate the contract if the market moves adversely to it, the broker may require an additional margin deposit if the market price of the trader's contract falls.[271] An additional deposit may also be called for if the exchange alters the amount of margin required on a particular contract.[272] If a customer fails to meet a margin call, the FCM will immediately liquidate his position; the customer will be liable for any losses caused by a decline in the value of the con-

266. *See* Pub. L. No. 93-463, § 213, 88 Stat. 1404.

267. The act does grant the Commission emergency power to "direct the . . . market" whenever "an emergency exists," however, and the term "emergency" includes any "major market disturbance which prevents the market from accurately reflecting the forces of supply and demand . . . ." Pub. L. No. 93-463, § 215, 88 Stat. 1405. This provision arguably gives the Commission authority to determine margins in rare situations.

268. *See, e.g., 1973 House Hearings, supra* note 50, at 93 (statement of H. Christopher, President, The Board of Trade of Kansas City, Missouri, Inc.), *id.* at 109-11 (statement of R. Clark, representing the New York Coffee & Sugar Exchange, Inc.), *id.* at 146 (statement of W. Brooks, President, National Grain Trade Council, Washington, D.C.); *1974 Senate Hearings, supra* note 37, at 287 (statement of C. Bradley, President, Board of Trade of Kansas City, Mo., Inc.); *id.* at 336-37 (statement of L. Melamed, Chairman, International Monetary Market, Chicago Mercantile Exchange); *id.* at 392 (statement of Dr. R. Dahl, Professor, University of Minnesota); *id.* at 447-48 (statement of F. Rhodes, President, New York Cotton Exchange); *id.* at 493-94 (appendix to statement of C. Chapin, representing the New York Coffee & Sugar Exchange, Inc., the New York Cocoa Exchange, and The Commodity Exchange, Inc.); *id.* at 516-17 (statement of P. Franklin, Vice-President, Merrill Lynch, Pierce, Fenner & Smith).

269. T. HIERONYMUS, *supra* note 11, at 62-65.

270. *See 1974 Senate Hearings, supra* note 37, at 493.

271. *See* H.R. REP. No. 93-963, *supra* note 142, at 17-18.

272. *Id.*

tract prior to liquidation.[273] Brokerage firms that are members of an exchange's clearing house must keep the set minimum amount of margin money on deposit at the clearing house.[274] As described earlier,[275] the clearing house determines a settlement price for contracts each day, and members either receive or pay money to the clearing house depending on whether they have a surplus or deficiency in their margin accounts. Normally, the initial margin adjustments will be a day's only margin transaction, but a member may be asked to deposit additional margin on an hour's notice when market prices move very rapidly.[276]

There has been great confusion over the effects of changes in margin requirements during periods of large market fluctuation. Two government statements that argued that the federal government should be given increased authority over margins gave diametrically opposed reasons for their conclusions.[277] In 1966 the Department of Agriculture favored government authority to establish minimum margin requirements when "there is reason to believe there is danger of price manipulation, or unreasonable sudden price fluctuations or unwarranted changes in price, excessive speculation, or any other activity reasonably expected to restrain trade."[278] An Assistant Secretary explained that, during some major fluctuations, the raising of margins would help to prevent excessive speculation.[279] In contrast, the 1974 report of the House Small Business Subcommittee argued that federal oversight of margins was needed to prevent the exchanges from raising margins unnecessarily in times of market fluctuation.[280] They were concerned that exchanges might raise margins to benefit certain trading interests at the expense of others. The report cited the complaints of legitimate hedgers who, during the 1973 rise in futures prices for soybeans

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273. *Id.*

274. For more detail on clearing house operations, see CHICAGO BOARD OF TRADE, *supra* note 204, at 29-34; T. HIERONYMUS, *supra* note 11, at 40-43.

275. *See* text at notes 22-24 *supra.*

276. *See* T. HIERONYMUS, *supra* note 11, at 42.

277. *Compare 1967 House Hearings, supra* note 265, at 10-32, *with* H.R. REP. No. 93-963, *supra* note 142, at 17-21.

278. *1967 House Hearings, supra* note 265, at 12.

279. *Id.* He argued that raising margins could prevent excessive speculation by retarding the buildup of large holdings of a particular futures contract by a small number of people, or by reducing the amount of such holdings already in existence. He pointed out that there were several instances in which exchange officials refused to heed the requests of the Department that margins be raised substantially in order to lessen excessive speculation. *Id.* at 29-30. The most noteworthy example occurred in 1947, when the exchanges refused to comply with a request by the Commodity Exchange Authority for higher margins that was intended to dampen soaring food prices. President Truman directly criticized the exchanges on the radio and proposed an amendment to the Commodity Exchange Act that would have authorized him to order compliance.

280. H.R. REP. No. 93-963, *supra* note 142, at 17-21.

and corn, had to incur substantial increases in costs simply to meet margin calls.[281] Many hedgers in fact were unable to meet the increased requirements and took losses on their contracts.[282]

Exchange officials point to such confusion as a reason why margins must be set by the exchanges, which are familiar with daily trading conditions, rather than by the government.[283] They also maintain that the only legitimate purpose of futures margins is to protect FCM's from losses that could be caused by unsecured debit balances in customers' accounts.[284] Accordingly, the exchanges argue that federal supervision is unwarranted. They reject any analogy to securities margins, which may be adjusted by the Federal Reserve Board,[285] because in contrast to the level of securities margins, the level of futures margins is allegedly of little direct importance to the rest of the economy.[286] Margins should thus be set as low as possible while still ensuring performance of contract commitments.[287] Exchanges favor low margins because high margins force hedgers to borrow more funds, and thereby to incur higher costs. Since costs are passed along to consumers, the public has an interest in low margin rates.[288]

Many of these arguments are indisputable. The conclusion to which they lead, however, may be challenged. Even accepting the assumption that the only function of margins is to protect FCM's, it does not follow that federal authorities have no valid regulatory objectives. Federal regulation seeks to ensure the existence of fair and open markets in which investors can have confidence; credit protection is surely an important part of this goal. Especially in

281. *Id.* at 19-21.

282. *See House Small Business Hearings, supra* note 38, at 21.

283. *See, e.g., 1974 Senate Hearings, supra* note 37, at 318, 493-94.

284. *See, e.g., id.* at 318, 447, 493.

285. Securities margin levels determine the proportion between the amount that is actually paid for securities and the amount that may be borrowed for their purchase. The Federal Reserve has authority to determine this proportion because margin levels provide a device by which to control credit and money supply for the economy. Because purchasers of futures contracts buy future obligations rather than shares representing the ownership of actual assets, the exchanges argue that futures margin changes have no effect on the nation's money supply. *See 1974 Senate Hearings, supra* note 37, at 493.

For comparisons of the functions of futures margins and securities margins, see ECONOMIC RESEARCH SERVICE, U.S. DEPT. OF AGRICULTURE, MARGINS, SPECULATION AND PRICES IN GRAIN FUTURES MARKETS 157-73 (1967) [hereinafter 1967 MARGIN STUDY]; R. TEWELES, C. HARLOW & H. STONE, *supra* note 6, at 14, 45-51; *1974 Senate Hearings, supra*, at 447 (testimony of F. Rhodes, President, New York Cotton Exchange); *id.* at 493 (appendix to statement of C. Chapin, representing the New York Coffee & Sugar Exchange, the New York Cocoa Exchange, and The Commodity Exchange, Inc.).

286. *See* note 285 *supra.*

287. *See 1974 Senate Hearings, supra* note 37, at 414 (statement of A. Donahoo, Executive Vice-President, Minneapolis Grain Exchange, Minneapolis, Minn.).

288. *See, e.g., id.* at 447 (statement of F. Rhodes, President, New York Cotton Exchange); *id.* at 494 (appendix to statement of C. Chapin).

times of high prices and volatile markets reflecting food shortages and inflation,[289] the risks created by inadequate safeguards on market credit are great. Problems are most likely to arise on the smaller exchanges, which occasionally attempt to attract business by setting low margin levels. Federal regulatory authority is necessary to prevent dangerously low margins from leading to serious financial losses for brokerage houses or even to the collapse of an exchange.

Federal oversight of margin requirements would also help to control speculation. The exchanges argue against this proposition,[290] citing a 1966 study of futures margins done for the Department of Agriculture.[291] They present the study as evidence that speculation often moderates price volatility, and that raising margins in order to reduce speculation will actually harm hedgers, without reducing market movements.[292]

The results of the 1966 study are not nearly as conclusive as the exchanges suggest. It is not clear that margin levels could not be used to control speculation. In its final recommendations, the study does suggest that federal interference in setting margin levels would be unwise.[293] This recommendation is based in part on evidence that small increases in margin levels have tended to correspond with increased market volatility.[294] The study cautioned, however, that the correlation may have occurred because the margin increases were made when greater fluctuations were expected, or because many brokers did not comply with the changes in margins, which the exchanges were lax in enforcing. If the federal authorities had enforced the margin changes, the study noted, the results might have been different.[295] Furthermore, in the one instance when large increases in margin requirements were made, there was a prompt reduction in price fluctuations.[296] And, as the study points out, it is only when major margin changes are needed that federal authorities are likely to intervene.[297]

In properly evaluating the study's recommendation against federal oversight of margins, it is important to remember that the study

289. *See, e.g.*, Thackray, *The Perilous Present for Commodity Futures*, MONEY, Aug. 1973, at 28; BUS. WEEK, Dec. 22, 1973, at 118; FORBES, Aug. 1, 1973, at 25; FORTUNE, July 1973, at 65; TIME, April 2, 1973, at 84.

290. *See 1974 Senate Hearings*, *supra* note 6, at 337 (testimony of L. Melamed, Chairman, International Money Market, Chicago Mercantile Exchange); *id.* at 493 (testimony of C. Chapin).

291. *See* 1967 MARGIN STUDY, *supra* note 285.

292. *See 1974 Senate Hearings*, *supra* note 37, at 493 (appendix to statement of C. Chapin).

293. 1967 MARGIN STUDY, *supra* note 285, at 8.

294. *Id.* at 191-93.

295. *Id.* at 192-93.

296. *Id.* at 142-43.

297. *Id.* at 194.

was addressing regulation by the Commodity Exchange Authority as of 1966. The report concluded that prompt, accurate determinations of when to apply margin controls to moderate excessive price fluctuations would require "highly sophisticated systems of market data collection and tabulation . . . ."[298] Such systems were not available to the Authority in 1966. In light of the tremendous increase in the amount and the sophistication of the data that will be available to the new Commission,[299] the current import of the report must be questioned. New, detailed studies of the impact of changes in margins on controlling excessive speculation must be undertaken before the Commission is permanently deprived of regulatory authority in this area.

A final argument against federal oversight raised by the exchanges is that proper margins are so essential to the markets that unwise federal intervention could "effectively destroy futures trading . . . ."[300] Exchange officials should set margins, the argument goes, because they are closest to the trading floor and their knowledge and experience makes them best able to weigh the interests of the diverse groups affected by margin levels.[301] Federal authorities would be too remote to make quick and accurate decisions.[302]

This argument ignores the potential conflicts of interest that may arise if exchanges are free to set margin levels without federal oversight. The boards of most exchanges are dominated by representatives of FCM's and floor traders,[303] and it is the board that sets margin levels. Because margin changes can be used to raise or lower commodity prices,[304] there may be a conflict between the public responsibilities of exchange directors and their personal interests in price movements. For this reason some have actually demanded that federal authorities oversee all exchange margin decisions.[305] The majority sentiment, however, would leave the day-to-day setting of margin levels to the exchanges. Thus, most recent legislative

298. *Id.* at 9.

299. *See, e.g.*, FUTURES DATA REPORT, *supra* note 113.

300. *1974 Senate Hearings, supra* note 37, at 493 (testimony of C. Chapin, representing the New York Coffee & Sugar Exchange, the New York Cocoa Exchange, and The Commodity Exchange, Inc.).

301. *See, e.g., 1973 House Hearings, supra* note 50, at 70 (testimony of A. Donahoo, Secretary, Minneapolis Grain Exchange); *id.* at 93 (testimony of H. Christopher, President, The Board of Trade of Kansas City, Missouri, Inc.); *House Small Business Hearings, supra* note 38, at 162-63 (testimony of F. Uhlmann, Chairman, Board of Trade of the City of Chicago).

302. *See 1974 Senate Hearings, supra* note 37, at 453, 493-94.

303. Interview with Edward De Moch, Commodity Market Specialist, Associated Press, in Chicago, July 26, 1973. *See also* note 159 *supra.*

304. *See 1974 Senate Hearings, supra* note 37, at 339 (testimony of L. Melamed, Chairman, International Monetary Market, Chicago Mercantile Exchange).

305. *See, e.g.*, H.R. REP. No. 93-963, *supra* note 142, at 21; *1974 Senate Hearings, supra* note 37, at 208-09 (testimony of Representative Smith).

proposals have given federal authorities only minimal oversight functions.[306]

There are some steps that federal authorities might take to guarantee adequate margins that would not involve federal determination of margin amounts. One such measure would change the manner in which clearing members' margin deposits with the exchange clearing houses are computed. Currently, initial margin deposits are requested of clearing members only for their net long or short position in a commodity.[307] Thus, a clearing member firm that has both a short position—for the sale of 50 May corn futures contracts—and a long position—for the purchase of 100 May corn contracts—would be required to deposit margin money only on its net long position of 50 May corn futures contracts. Since the firm will be owed margin money from both its long and its short customers, but need pay only on its net position, it may be lax in determining the reliability of its customers and in requiring them to keep minimum margin amounts on hand.[308] Because of this practice, firms will often wait some time before liquidating the contracts of a delinquent customer who has lost on the market.

A preferable system would require clearing members to deposit margins on both their long and short positions with the clearing house. Such a requirement would encourage greater caution on the part of FCM's in dealing with their customers,[309] especially in this period of high prices and costly market fluctuations.[310] To minimize federal intrusion, the authority to tighten margin requirements in this manner might be made discretionary rather than mandatory.

Another way for the Commission to supervise margin levels without interfering directly in their determination would be to develop a general margin formula. Some have suggested that careful study would reveal that safe margin levels are functions of prices and trading conditions.[311] The Commission, in cooperation with the exchanges, could develop margin tables that would specify acceptable margin spreads according to price level, price volatility, trading

306. *See, e.g.*, H.R. 11788, 89th Cong., 1st Sess. § 13 (1966); S. 2578, 93d Cong., 1st Sess. § 11 (1973); S. 2837, 93d Cong., 1st Sess. § 201 (1973). *See also 1974 Senate Hearings, supra* note 37, at 453.

307. *See* CHICAGO BOARD OF TRADE, *supra* note 204, at 31.

308. Raclin Interview, *supra* note 245.

309. Raclin Interview, *supra* note 245. Raclin also noted that such a system would prevent the possibility of an account executive or back office employee hiding his own transactions against the company's net position. *Id. See also* Wall St. J., Oct. 23, 1974, at 9, col. 2 (midwest ed.).

310. *See* materials cited note 289 *supra*.

311. *See, e.g., 1973 House Hearings, supra* note 50, at 48-49 (testimony of R. Richards, representing the National Grain & Feed Association); *id.* at 76 (testimony of A. Donahoo, Secretary, Minneapolis Grain Exchange); Interim Report of the Comptroller General on Commodity Futures Trading, May 3, 1974, in *1974 Senate Hearings, supra* note 37, at 199.

volume, and other significant factors.[312] Such tables need not be binding on the exchanges, and particular conditions might require deviations from them. However, they would provide a general guide that could at least help hedgers anticipate their margin costs and signal authorities as to unusual margin requirements.

In addition to these measures, the Commission should request authority to intervene in margin determination in times of unusual market stress or volatility.[313] The mere possibility of action by federal regulators will encourage exchanges to cooperate with federal regulators and to maintain adequate credit safeguards. Although exchange officials have argued that federal regulators might use such authority unnecessarily,[314] this argument has little merit. The 1974 Act expressly provides that the new Commissioners shall include persons knowledgeable about futures trading.[315] It seems unlikely that such individuals would use their authority without reason.

VI. Conclusion

When legislation is enacted that delegates difficult decisions to a regulatory body, its ultimate success depends on that body's interpretation of its mandate. Such is the case with the 1974 Commodity Futures Trading Commission Act. The choices before the Commission are not easy. While its first task must be to gather better and more complete information, at some point the Commission must make use of its new decision-making authority. If the Commissioners choose to rely on the familiar industry shibboleths of futures regulation, their increased authority will mean little. If, instead, they take a fresh approach, they may be plagued by their lack of authority in some areas. Their effectiveness will depend on their skill in exploring new alternatives, both in those areas opened to them by the new Act and in those still not within their power.

312. *See 1973 House Hearings, supra* note 50, at 48.

313. It has been suggested that federal authorities should intervene in setting margin levels only when there are particular problems to be solved, and when radical changes in margin setting procedure or margin levels are necessary. 1967 MARGIN STUDY, *supra* note 285, at 193-94.

314. *See, e.g., 1974 Senate Hearings, supra* note 37, at 453 (testimony of F. Rhodes, President, New York Cotton Exchange).

315. Pub. L. No. 93-463, § 101, 88 Stat. 1389.